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# Retirement Revolution: Unmitigated Risks in the Defined Contribution Society

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# ARTICLE

## RETIREMENT REVOLUTION: UNMITIGATED RISKS IN THE DEFINED CONTRIBUTION SOCIETY

*Anne Tucker\**

### ABSTRACT

A revolution in the retirement landscape over the last several decades shifted the predominant savings vehicle from traditional pensions (defined benefit plans) to self-directed accounts in defined contribution plans like the 401(k) and has drastically changed how people invest in the stock market and why. The prevalence of these self-directed accounts has created our defined contribution society and a new class of investors—the citizen shareholders—who enter the private securities market through self-directed retirement plans, invest for long-term savings goals, and are predominately indirect shareholders. With 90 million Americans invested in mutual funds, and nearly 75 million who do so through defined contribution plans, citizen shareholders are the fastest growing group of investors. Yet, citizen shareholders have the least protections despite conventional wisdom that corporate law and ERISA protections safeguard both these investors and their investments. As explained in an earlier paper, citizen shareholders do not fit neatly within the traditional corporate law framework because their investment within a defined contribution plan restricts choice and their indirect ownership status dilutes their

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\* Assistant Professor of Law, Georgia State University College of Law. Helpful comments from experts in corporate law and ERISA include Kent Greenfield, Joan Heminway, Lyman Johnson, Lynn Stout, Ellen Taylor, and Mary Radford. Additionally participating in the Georgia State University College of Law Faculty Workshop series and the thoughtful comments of my many colleagues significantly advanced this draft. Also Carly Alford, my GRA, deserves recognitions for her fine research and editing assistance.

information and voting rights, as well as exacerbates their rational apathy as diffuse and disempowered “owners.”

The retirement revolution from pensions to 401(k) has changed not only how individuals prepare for retirement but also who bears certain risks that affect the retirement nest egg. Under self-directed defined contribution plans, but not defined benefit plans, citizen shareholders bear the risks of poor market performance, longevity, and information asymmetries, as well as plan administrative costs and life-long responsibility of asset management. Research indicates that citizen shareholders, particularly those who are women, minorities, and those with lower education levels, often lack the financial literacy necessary to maximize both individual and society-wide retirement savings. These changes, and their consequences, are firmly established in our defined contribution society and are a result of the retirement revolution. Yet, these changes are not widely understood by individuals saving for retirement, nor have they been incorporated into how we think and talk about shareholders in and outside of the academy. In this Article, I build on previous work, which articulated the citizen shareholder status and its incompatibility with traditional corporate law, by identifying and explaining the second prong—that citizen shareholders have substantially weakened protections under ERISA and bear substantially increased risks and responsibility in our defined contribution society. I suggest that these risks could be better managed and mitigated through a series of structural and individually focused reforms.

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## I. INTRODUCTION

For young workers, saving for retirement is an unpleasant eventuality that promises stress and poses future risks far too great to imagine today. Little changes as workers age—retirement still feels far off and many intervening events have yet to occur. With thirty years to accumulate a nest egg and the hope for future increased savings or a booming stock market, workers tend to save too little, generally pay inadequate attention to retirement planning, and raid accumulated savings even though these actions have tremendous potential for personal detriment. The average 401(k) balance is \$80,900<sup>1</sup> while the average for workers reaching retirement age is \$200,000.<sup>2</sup>

1. Ashlea Ebeling, *Fidelity: 401(k) Balances Reach Record Highs*, FORBES (May 23, 2013, 2:30 PM), <http://www.forbes.com/sites/ashleaebeling/2013/05/23/fidelity-401k-balances-reach-record-highs/>.

2. INV. CO. INST., 2013 INVESTMENT COMPANY FACT BOOK 121 (53d ed. 2013), available at [http://www.icifactbook.org/pdf/2013\\_factbook.pdf](http://www.icifactbook.org/pdf/2013_factbook.pdf) (reflecting the average savings of workers over age sixty who have been with their current employer for thirty years or more). The reader should note that the number is reported as an average, which can be skewed by high earners with substantial accumulated savings, and it is not the mode, which reflects the most common occurring account balance.

While not an insignificant amount of savings, it is insufficient to meet most modest estimates of retirement savings needs when variables such as life expectancy, market volatility, and long-term care costs are taken into account.<sup>3</sup>

The average American employee saving for retirement does so through investments pooled in an individual account found in self-directed defined contribution plans,<sup>4</sup> like the 401(k)—the subject of this Article. The growing ubiquity of these self-directed retirement accounts gave birth to the retirement revolution and the resulting defined contribution society,<sup>5</sup> where the majority of individual retirement savings are invested in private securities markets.

The retirement revolution promoted self-directed defined contribution plans, provided workers flexibility in the type of risk exposure they choose, and facilitated greater job mobility.<sup>6</sup> For most workers, long gone are the days of weighing alternative job

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3. Dan Kadlec, *Sizing Up the Big Question: How Much Money Do You Need to Retire?*, TIME (Feb. 11, 2013), <http://business.time.com/2013/02/11/sizing-up-the-big-question-how-much-money-do-you-need-to-retire/> (stating that due to factors such as life expectancy, medical costs, and inflation, “by age 65 an average full time career worker needs to have banked 11 times annual pay. . . . [meaning] a household earning \$75,000 a year would need to have saved \$825,000”).

4. Alicia H. Munnell, *Employer-Sponsored Plans: The Shift from Defined Benefit to Defined Contribution*, in OXFORD HANDBOOK ON PENSIONS AND RETIREMENT INCOME 359, 365–66 (Gordon L. Clark et al. eds., 2006). Common defined contribution plans include Money Purchase plans, Target Benefit plans, Profit Sharing plans, 401(k) plans, Stock Bonus plans and Employee Stock Ownership plans. See generally Phyllis C. Borzi, *ERISA: A Basic Approach to Key Terms and Concepts Under Title I of ERISA*, in 1 ERISA BASICS, at A-9, A-16 (ABA ed., 2011). The distinguishing feature of self-directed defined contribution plans, which is the subject of this paper, is that employers provide separate benefit accounts that the plan maintains for each participant. BARRY KOZAK, *EMPLOYEE BENEFIT PLANS* 84–85 (2010). Participants direct the investment allocation in these accounts and employers may provide a matching or minimum level of contribution to the account as well. See, e.g., *403(b) Plan Basics*, IRS (Feb. 2013), <http://www.irs.gov/publications/p571/ch01.html>; *IRC 457(b) Deferred Compensation Plans*, IRS (Feb. 2013), [http://www.irs.gov/Retirement-Plans/IRC-457\(b\)-Deferred-Compensation-Plans](http://www.irs.gov/Retirement-Plans/IRC-457(b)-Deferred-Compensation-Plans) (describing how contributions are made to the plan). At retirement, a participant’s retirement benefits are limited to the amount in the account. KOZAK, *supra*, at 86. 403(b) plans, available for employees of public schools, employees of certain tax-exempt organizations, and certain ministers, and 457 plans, available for certain state and local governments and nongovernmental entities tax exempt under IRC 501, are also self-directed accounts. *403(b) Plan Basics*, *supra*; *IRC 457(b) Deferred Compensation Plans*, *supra*.

5. “In a defined contribution society, the policies more likely to be adopted are those that channel government subsidies through individual accounts controlled by the taxpayer herself.” Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 453 (2004).

6. See ALICIA H. MUNNELL & ANNIKA SUNDÉN, *COMING UP SHORT: THE CHALLENGE OF 401(K) PLANS* 16, 19 (2004) (discussing the shift of responsibility from employers to employees and that, once vested, an employee will not forfeit benefits when changing employers).

opportunities against lost retirement income under traditional defined benefit plans, referred to as pensions.<sup>7</sup> In defined benefit plans, employers sponsored, funded, managed, and paid guaranteed benefits upon retirement, often for the life of the employee.<sup>8</sup> In self-directed defined contribution plans, employers provide investment portals for employees to contribute money, often matched by employers, into individual accounts that are invested by the employee in employer-chosen investment instruments.<sup>9</sup> I discuss the distinctions between the two regimes, and the consequences of each, in detail in the following pages. It may be useful at the outset to think of defined benefit regulations as focused on outputs—employers guaranteeing retirement payments—whereas regulations governing self-directed defined contribution plans are focused on inputs—employers facilitating employee savings and investment for retirement.

Unless you are already retired, you are, or will soon be, saving for retirement like the 92.4 million Americans invested in mutual funds,<sup>10</sup> nearly 75 million of whom do so through defined contribution plans.<sup>11</sup> “Assets in employer-sponsored DC plans have grown more rapidly than assets in other types of . . . retirement plans over the past quarter century . . . .”<sup>12</sup> 401(k)s and other employer-sponsored defined contribution plans held over \$5 trillion in assets at the end of 2012.<sup>13</sup> The result is a retirement revolution that has resulted in a defined contribution society, where increasingly the average worker saves for retirement by investing in private securities markets and becoming a shareholder.<sup>14</sup>

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7. *Id.* at 15–16, 40–41.

8. *See infra* Part II.B.1.

9. *See infra* Part II.B.1–3; *see also* Borzi, *supra* note 4, at A-15 to A-16 (describing defined contribution plans under ERISA).

10. INV. CO. INST., *supra* note 2, at 91.

11. *Private Pension Plan Bulletin: Abstract of 2010 Form 5500 Annual Reports*, U.S. DEP’T OF LABOR 1 (Nov. 2012), <http://www.dol.gov/ebsa/PDF/2010pensionplanbulletin.pdf> (summarizing 2010 data regarding the number of current defined contribution participants). The 75 million figure reflects current participants and does not include former participants who have changed jobs or retired and converted accumulated defined contribution benefits into an individual savings account (IRA).

12. INV. CO. INST., *supra* note 2, at 116.

13. *Id.* at 94.

14. *See* Zelinsky, *supra* note 5, at 453–54.

In a defined contribution society, the policies more likely to be adopted are those that channel government subsidies through individual accounts controlled by the taxpayer herself. . . . As a result of the increasing prevalence of defined-contribution-type programs, upper-middle-class taxpayers can in practice undertake all of their financial savings for

This growing class of investors—the “citizen shareholders”—have commonalities in how they enter the market, in what they invest, and why.<sup>15</sup> This Article is the second of three pieces examining the evolving ways in which Americans invest and the causes and consequences of such changes. The first article articulated the early concept of the citizen shareholder, a definition that is refined and focused in this paper, as investors, who enter the securities market primarily through self-directed defined contribution plans,<sup>16</sup> invest in mutual or index funds and are saving for long-term goals like retirement. Because citizen shareholders invest in private securities markets through employer plans, their investments are governed by the Employee Retirement Income Security Act (ERISA),<sup>17</sup> in addition to traditional corporate governance and securities statutes.<sup>18</sup>

The commonalities of how citizen shareholders enter the market, the constraints on their ownership rights, and the long-term time horizon of their investments distinguish them from both direct shareholders, who hold shares in individual

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retirement, education, and health outlays through tax-favored individual account devices.

*Id.*

15. Anne Tucker, *The Citizen Shareholder: Modernizing the Agency Paradigm to Reflect How and Why a Majority of Americans Invest in the Market*, 35 SEATTLE U. L. REV. 1299, 1302–06 (2012) (describing the changing landscape of individual securities investment and the resulting category of citizen shareholders). Delaware Chancellor Leo Strine has termed these investors the “forced capitalists”:

[M]ost ordinary Americans have little choice but to invest in the market. They are in essence ‘forced capitalists,’ even though they continue to depend for their economic security on their ability to sell their labor and to have access to quality jobs. These forced capitalists—in whose number I count myself—invest primarily for two purposes, both of which are long-term in focus: to send their children to college and to provide for themselves in retirement.

Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1, 4 (2007).

16. Citizen shareholders enter the market through employer-sponsored retirement plans, but when they reach retirement age the plan accumulations will be rolled into privately held, but often still, mutual or index funds. Tucker, *supra* note 15, at 1314. Additionally, citizen shareholders may supplement plan holdings by purchasing additional securities as a retail investor—someone who purchases mutual or direct funds outside of an employer-sponsored plan. *Id.* at 1301 n.9. The classification of citizen shareholder is still meaningful, however, as it describes *how* investors enter the market, their primary purpose, and the conditions upon which they first invest.

17. KOZAK, *supra* note 4, at 297.

18. Part III will provide a brief overview of corporate governance and securities regulations limitations for citizen shareholders. These issues, however, are largely beyond the scope of this paper and will instead be addressed in a third article tracking the consequences of the change in how investors enter the market, the protections available and the risks assumed.

companies, and indirect investors, who own shares in investment companies like mutual and index funds.<sup>19</sup>

The defined contribution society has created a growing class<sup>20</sup> of citizen shareholders who do not fit neatly into the traditional corporate law governance structure.<sup>21</sup> Much of the corporate law literature and doctrine remains focused on the direct shareholder,<sup>22</sup> a significant group in terms of investing volume, but a group that is not representative of the 92.4 million indirect, mutual fund owners in the securities market.<sup>23</sup> Direct shareholders own stock in individual companies such as Coca-Cola or Facebook and exercise shareholder information, voting, and exit rights directly.<sup>24</sup> In contrast, citizen shareholders own stock in mutual or index funds that are made up of stock from hundreds of companies, and on whose behalf representatives, like mutual fund managers, utilize shareholder information and exercise voting and exit rights.<sup>25</sup> Mutual and index funds, as well as hedge funds, are investment companies.<sup>26</sup> They, together with pension funds, such as CalPERS, are referred to as intermediaries in this Article and also as institutional shareholders in corporate law literature.<sup>27</sup> In teaching and thinking about corporate law, I use the following simple

19. Tucker, *supra* note 15, at 1309.

20. "There were 20,035 [defined benefit] plans and 8,587 [defined contribution] plans with more than 100 participants in 1975, but only 11,368 [defined benefit] plans and 70,125 [defined contribution] plans with more than 100 participants in 2006." Martin Gelter, *The Pension System and the Rise of Shareholder Primacy*, 43 SETON HALL L. REV. 909, 923 (2013). In 2012, \$5,057 billion was invested in defined contribution plans such as 401(k), 403(b), 457, and other plans. INV. CO. INST., *supra* note 2, at 117.

21. Corporate law is an umbrella term under which we examine the role and rights of direct shareholders, indirect shareholders, and the institutional shareholders. Similarly, both publically owned and privately owned companies are also examined under the heading of corporate law.

22. See, e.g., Larry Cata Backer, *Direct Shareholder Democracy: Reflections on Lucian Bebchuck*, 2 CORP. GOVERNANCE L. REV. 376 (2006); Elizabeth J. Thompson, *Direct Harm, Special Injury, or Duty Owed: Which Test Allows for the Most Shareholder Success in Direct Shareholder Litigation?*, 35 J. CORP. L. 215 (2009).

23. INV. CO. INST., *supra* note 2, at 91.

24. Tucker, *supra* note 15, at 1321–29 (describing the consequences of indirect stock ownership with respect to traditional shareholder rights).

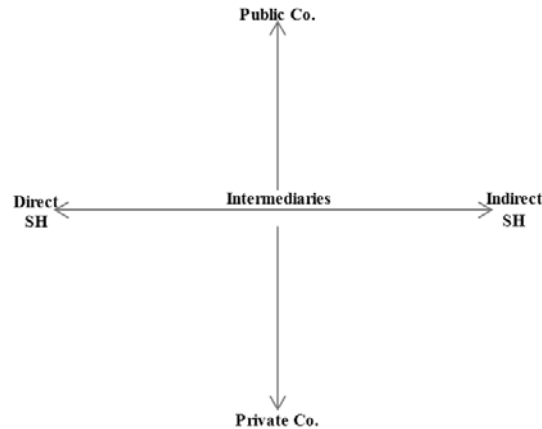
25. As is briefly discussed in Part III and the subsequent paper, representation by these managers does not cure the defect because their interests are not perfectly aligned with those of citizen shareholders. *Id.* at 1324.

26. ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, REPORT TO THE HONORABLE HILDA L. SOLIS, U.S. SECRETARY OF LABOR, HEDGE FUNDS AND PRIVATE EQUITY INVESTMENTS 9 (2011), available at <http://www.dol.gov/ebsa/pdf/2011ACReport3.pdf>.

27. See, e.g., Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 SEATTLE U. L. REV. 877, 880, 882 (2010) (describing mutual funds as diversified institutional shareholders); CalPERS, *Facts at a Glance* 1 (Sept. 2013), <http://www.calpers.ca.gov/eip-docs/about/facts/facts-at-a-glance.pdf> (reporting average monthly pension information).



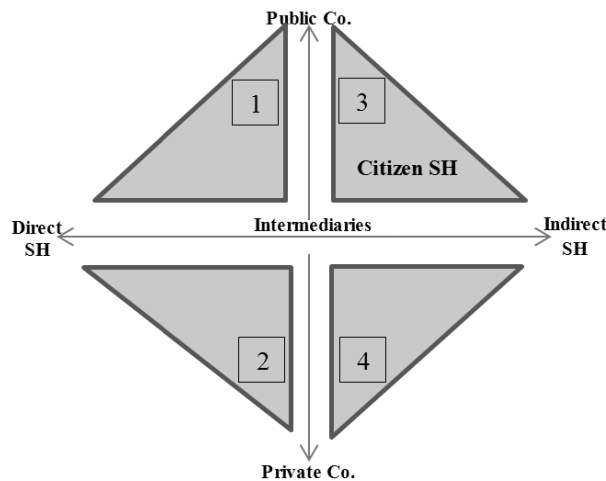
diagram to visualize both the distinct roles of these various groups and the relationship between them.



This diagram illustrates one way to think about the changing roles and rights of shareholders as they move from direct through intermediaries to indirect shareholders and between public and private companies. Fundamental shareholder rights such as information and voting rights remain constant between private and publically owned corporations, and yet there are significant distinctions between the two in terms of exit rights such as the ready market to sell shares that is available in most public corporations, but usually not with private corporations.<sup>28</sup> Another important area of distinction is the ability for shareholders to exercise meaningful voting rights. The smaller pool of owners in private corporations tends to make voting rights more meaningful than with public companies, which often have millions of outstanding shares and shareholders. In a prior article, I highlighted the fixation of corporate law on the direct shareholder in public companies; that limited sphere is illustrated below in quadrant number 1. In this Article, I examine the unique needs of citizen shareholders who occupy both quadrants 3 and 4, but predominantly focus on quadrant 3 as indirect investors primarily in public companies.<sup>29</sup>

28. *E.g.*, Tucker, *supra* note 15, at 1304 (describing the importance of exit rights).

29. Participants in self-directed defined contribution plans can invest in private equity and hedge funds in one of three ways. The first is if he or she qualifies as an accredited investor or as a qualified purchaser and then can invest directly in the hedge or private equity fund. *See* 15 U.S.C. § 80a-3(c)(1), (7) (2006) (defining “accredited investor” and “qualified purchaser”). Second, a participant may invest in a fund and the fund invests in private equity and hedge funds so that the participant is an indirect owner and the fund a qualified purchaser or accredited investor. ADVISORY COUNCIL ON EMP. WELFARE AND PENSION BENEFIT PLANS, *supra* note 26, at 9. Third, participants in self-directed defined contribution plans “may have exposure to hedge funds and/or private equity funds when the plan includes as part of its investments options target-date funds,



While corporate law, securities regulations,<sup>30</sup> and the Employee Retirement Income Security Act (ERISA)<sup>31</sup> govern retirement investments, the protections offered under these frameworks are largely obsolete for citizen shareholders.<sup>32</sup> And yet, their retirement investments perform an individually crucial function of providing financial solvency in retirement and a socially vital function of preserving the retirement safety net. There is little scholarship exploring the relationship between corporate law, securities law principles,<sup>33</sup> and ERISA; this Article

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lifecycle funds or other managed funds which may invest a portion of their assets in hedge funds and/or private equity funds.” *Id.*

30. Part III will provide a brief overview of corporate governance and securities regulations limitations for citizen shareholders. These issues, however, are largely beyond the scope of this paper and will instead be addressed in a third article tracking the consequences of the change in how investors enter the market, the protections available and the risks assumed.

31. Certain plans that mimic defined benefit and defined contribution plans are not “qualified plans” under ERISA and therefore are not subject to certain ERISA regulations on funding and vesting. Borzi, *supra* note 4, at A-17. These plans include benefits offered by the government, public schools, nonprofit corporations, and church plans that do not opt-in to ERISA; plans established under workmen’s compensation, disability, or unemployment laws; plans outside of the United States; and excess benefit plans only offered to certain employees. 29 U.S.C. § 1101 (2006); KOZAK, *supra* note 4, at 51–61. Employer sponsors who are outside of the scope of ERISA and thus cannot offer qualified plans have alternative tax-deferred savings options available through Internal Revenue Code § 457(b) for government, church, and nonprofit employers and §§ 403(a)–(b) for schools, churches and nonprofit organizations. KOZAK, *supra* note 4, at 47–48; *see also* 29 U.S.C. § 1103(b) (declaring exceptions to § 1103(a)).

32. Tucker, *supra* note 15, at 1324. *See generally* Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisors to Advocate for Shareholders’ Rights*, 34 J. CORP. L. 843 (2009) (discussing the failure of corporate law to protect mutual fund investors, the majority of which meet the definition of a citizen shareholder).

33. For a general overview of the existing literature on the retirement revolution and the resulting changes in the corporate governance framework, *see* the following sources: MUNNELL & SUNDÉN, *supra* note 6, at 65, which describes the risks and limitations of defined

highlights where these regulatory frameworks overlap and examines how the defined contribution society shifts risks onto the citizen shareholder under ERISA. A future article will focus on the structural problems with corporate and securities law.<sup>34</sup> The shifting risks of market performance, longevity, and information have potential to impact retirement security. These risks, however, are neither readily apparent to participants nor fully understood and are risks that can be better managed once we accept the reality, dominance, and import of the citizen shareholder.<sup>35</sup>

The remainder of this Article is organized in five parts. I document the historical and regulatory genesis for the rise of self-directed defined contribution plans and provide a brief overview of ERISA in Part II. In Part III, I briefly summarize the alienation of citizen shareholders from traditional corporate law rights, as described in earlier works,<sup>36</sup> and securities regulations setting up inquiries, which will be the focus of the third article. In Part IV, I describe the fundamental shifting of risks to employees and retirees under the defined contribution framework. In Part V, I discuss the limitations of diluted fiduciary standards and oversight of self-directed defined contribution plans. Part VI offers concluding observations about the overlap of the regulatory frameworks and their insufficiencies to serve the interests of citizen shareholders. It also offers initial suggestions for structural and individual reforms.

## II. EVOLVING INVESTMENT IN THE RETIREMENT REVOLUTION

Citizen shareholders are the consequence of a retirement revolution, and they are also a potential catalyst for corporate law reform.<sup>37</sup> Changes in tax and retirement benefit laws under ERISA

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contribution plans, while focusing in particular on investor financial illiteracy and the consequences on savings; Fisch, *supra* note 27, at 879–80, which provides a detailed analysis of indirect investors and their limited role in traditional corporate governance mechanisms; Gelter, *supra* note 20, at 911–12, which describes the relationship between defined contribution plans increasing the number of investors and the role of markets to push the dominance of shareholder primacy; Colleen E. Medill, *Transforming the Role of the Social Security Administration*, 92 CORNELL L. REV. 323, 329–31 (2007), which criticizes investor education given the role of self-directed retirement savings and the responsibilities placed on individual investors; and Zelinsky, *supra* note 5, at 455, 458, 473, which notes the rise of the defined contribution society, the difference between defined benefit and defined contribution plans, the shifting risks with defined contribution plans, and the tax consequences.

34. See generally Anne M. Tucker, *The Outside Investor: Citizen Shareholders & Corporate Law Alienation*, 10 U. ST. THOMAS L.J. (forthcoming 2013).

35. See *infra* Part IV.

36. See Tucker, *supra* note 15, at 1308; *supra* note 34.

37. See *infra* Part III.

created and promoted self-directed defined contribution plans, like the 401(k), which funneled investors into private securities markets.<sup>38</sup> Self-directed defined contribution plans are the dominant vehicles of individual retirement savings and have created both a growing class of employees who invest in capital markets and a resulting defined contribution society.<sup>39</sup> Payments from self-directed defined contribution plans are based exclusively on the accumulation of contributions (from employees and any employer-matching contributions) and investment earnings in individual accounts.<sup>40</sup> Corporate and securities laws thus govern the rights of these investments in private securities markets.<sup>41</sup> Employers provide access to markets through sponsored-benefit plans,<sup>42</sup> so investors also fall within the regulatory framework of ERISA.<sup>43</sup> The proliferation of the defined contribution plan, and thus the citizen shareholder status, is due in part to the regulatory evolution of ERISA since it was enacted in the 1970s.<sup>44</sup> This Part provides an overview of ERISA and documents the role ERISA regulations played in creating and continuing the defined contribution trend.

#### A. *ERISA: History and Purpose*

ERISA, signed into law on Labor Day in 1974,<sup>45</sup> was the first comprehensive employee benefit legislation in response to abuses<sup>46</sup> of employer and union retirement plans,<sup>47</sup> including

38. See JAMES A. WOOTEN, *THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: A POLITICAL HISTORY* 278–79 (2004) (discussing the shift from defined benefit plans to defined contribution plans after ERISA was enacted).

39. Zelinsky, *supra* note 5, at 471–72; see INV. CO. INST., *supra* note 2, at 114–15 (examining the increase in assets in defined contribution plans).

40. I.R.C. § 414(i) (2006); KOZAK, *supra* note 4, at 79.

41. See, e.g., Borzi, *supra* note 4, at A-12 (stating ERISA “grants substantive rights to employees and their beneficiaries”).

42. Throughout this Article, employer sponsors of defined contribution plans are referred to as “employers.”

43. Employee Retirement Income Security Act of 1974 (ERISA) Pub. L. No. 93-406, 88 Stat. 829 (codified in part at 29 U.S.C. § 1002 (2006)).

44. WOOTEN, *supra* note 38, at 278.

45. Employee Retirement Income Security Act of 1974 (ERISA) Pub. L. No. 93-406, 88 Stat. 829 (codified in part at 29 U.S.C. § 1002).

46. “Legislative materials dating to the enactment of ERISA thoroughly illustrate congressional concern with protecting plan assets from malfeasance and misuse. Representatives recognized the threat posed by the then-existing abuses of pension plan assets.” Dana M. Muir, *Fiduciary Status as an Employer’s Shield: The Perversity of ERISA Fiduciary Law*, 2 U. PA. J. LAB. & EMP. L. 391, 398 (2000). ERISA replaced the first legislative attempt to regulate pensions in the former attempt of the Welfare and Pension Plan Disclosure Act. 29 U.S.C. §§ 301–309 (1982), *repealed by* Pub. L. 93-406, Title I, § 111(a)(1), Sept. 2, 1974, 88 Stat. 851.

47. Retirement benefits are voluntary, but once they are promised and if they meet

failure of large employers (or unions) to deliver the benefits they had promised (whether due to economic reality, negligence or malfeasance), improper use of plan assets, inadequate advance funding, excessive periods of required service as an employee before . . . a portion of the benefits was vested . . . and the failure to cover a fair cross-section of lower-paid employees.<sup>48</sup>

The central purpose of ERISA was to “prevent the ‘great personal traged[ies]’ of workers whose pension plans terminated without having sufficient assets to pay promised benefits.”<sup>49</sup>

Defined benefit plans—traditional pension plans where retired employees received fixed-sum payments from employers based on salary and years of service<sup>50</sup>—were the predominant

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the standards of a “qualified plan,” then they are subject to ERISA. Plans are classified according to the type of benefit offered. Guaranteed payments provided by the employer after retirement, usually based upon a formula of service years and salary, are called defined benefit plans. When each employee funds separate retirement savings accounts, often comprised of stock investments, by employee contributions and possibly matching contributions by the employers, these plans fit the defined contribution model. Borzi, *supra* note 4, at A-15 to A-16. ERISA plans are also categorized according to which entity or entities sponsor a plan. For example, ERISA refers to the employer sponsor of the plan as either a single employer sponsor (Single Employer Plan), an employee association sponsor (Multiemployer Plan, like a plan offered under a collective bargaining agreement), or a multiple employer sponsor (Multiple Employer Plan, usually a trade association or national union). *Id.* at A-14, A-19. ERISA, however, also covers what is known as welfare benefit plans, which provide various health, disability, and insurance benefits to employees. *Id.* at A-16 to A-17. Employee welfare plans are outside of the scope of this Article.

48. KOZAK, *supra* note 4, at 28.

49. Muir, *supra* note 46, at 398.

The catalyst for the passage of the ERISA was the shutdown of the Studebaker plant in South Bend, Indiana, in 1963, which left many employees without their promised pension. After a decade of study by congressional committees, the ERISA was introduced by liberal New York Republican Senator Jacob Javits, signed into law by President Ford, and became effective on Labor Day, September 2, 1974.

Neil A. Capobianco & José Martin Jara, *Hot Topics in ERISA Litigation: From Ongoing Class Action Challenges to the Upcoming Fee Disclosure Deluge*, RECENT CHANGES IN EMP. BENEFITS & EXECUTIVE COMPENSATION, Jan. 2011, 2011 WL 190437, at \*2. ERISA’s regulatory framework intended to balance protections to plan participants against undue administrative burdens for (voluntary) employer sponsors, as well as maintain plan flexibility. *Legislative History of the Employee Retirement Income Security Act of 1974*, 94th Cong. (2d Sess. 1976) (introductory remarks of Sen. Javits, Member, S. Comm. on Labor & Pub. Welfare) (“[M]indful that too much regulation . . . might discourage employers from offering plans, Congress sought to balance ‘the interests of employers . . . in maintaining flexibility in the design and operation of their pension programs and the need of the workers for a level of protection which will adequately protect their rights and just expectations.”); see also Medill, *supra* note 33, at 344–45.

50. Munnell, *supra* note 4, at 365 (giving the example of 1.5% of final three-year average pay for each year of service, which adds up to 30% of income for an employee with a twenty-year employment history with the firm).

form of retirement benefit at the time ERISA was enacted<sup>51</sup> with as many as 80% of employees enrolled in such plans.<sup>52</sup> ERISA regulations, therefore, focused on rules for funding, preserving, and paying those guaranteed benefits.<sup>53</sup> At ERISA's inception there were relatively few defined contribution plans, and none were self-directed.<sup>54</sup> Today, however, self-directed defined contribution plans dominate the retirement benefit landscape, giving rise to our defined contribution society.<sup>55</sup> Defined contribution plans involve employer promises to provide individual accounts as a savings vehicle for retirement.<sup>56</sup> These plans include money purchase plans, target benefit plans, profit sharing plans, stock bonus and employee stock ownership plans (ESOPs), as well as self-directed plans like the 401(k), which are the focus of this Article.<sup>57</sup> Employee contributions are often

51. "The predominant form of private pension was the defined benefit (DB) plan, under which an employee receives a pension of a specified amount upon retirement." Gelter, *supra* note 20, at 922; see MUNNELL & SUNDÉN, *supra* note 6, at 9 ("Technically, ERISA's provisions applied to both defined benefit and defined contribution plans. But the main thrust of the legislation was on the defined benefit side."); see also Steven Sass, *The Development of Employer Retirement Income Plans: From the Nineteenth Century to 1980*, in OXFORD HANDBOOK ON PENSIONS AND RETIREMENT INCOME 76, 84 (Gordon L. Clark et al. eds., 2007) (noting a "dramatic" expansion of coverage from 15% in 1940 to approaching 50% in 1980).

52. WOOTEN, *supra* note 38, at 278.

53. See 26 U.S.C. §§ 402(c), 408 (2006); see also Zelinsky, *supra* note 5, at 475–77 (discussing ERISA regulations).

54. Gelter, *supra* note 20, at 923, 931; see also WOOTEN, *supra* note 38, at 279 (stating that 401(k)s did not exist prior to the enactment of ERISA).

55. Gelter, *supra* note 20, at 931.

56. Borzi, *supra* note 4, at A-15.

57. Money purchase plans require the employer to contribute a fixed percentage of an employee's salary to the participant's account. *Choosing a Retirement Plan: Money Purchase Plan*, IRS, <http://www.irs.gov/Retirement-Plans/Choosing-a-Retirement-Plan-Money-Purchase-Plan> (last updated Sept. 3, 2013). In target benefit plans, a form of money purchase plans, employers contribute "to each participant's account an amount necessary to provide a target benefit specific in the plan." Borzi, *supra* note 4, at A-16. "A Profit Sharing Plan or Stock Bonus Plan is a defined contribution plan under which the plan may provide, or the employer may determine, annually, how much will be contributed to the plan (out of profits or otherwise). The plan contains a formula for allocating to each participant a portion of each annual contribution." *Retirement Plans, Benefits & Savings: Types of Retirement Plans*, U.S. DEP'T OF LABOR, <http://www.dol.gov/dol/topic/retirement/typesofplans.htm> (last visited Sept. 20, 2013). Stock bonus plans usually make contributions and distributions in the form of employer stock. Borzi, *supra* note 4, at A-16.

This Article focuses on self-directed defined contribution plans like the 401(k). Participants in a 401(k) "can elect to defer receiving a portion of their salary which is instead contributed on their behalf, before taxes, to the 401(k) plan. Sometimes the employer may match these contributions." *Retirement Plans, Benefits & Savings: Types of Retirement Plans*, *supra*. 401(k) plans are subject to special rules like contribution limits and are sometimes offered in conjunction with profit-sharing plans. Borzi, *supra* note 4, at A-16. In addition to 401(k) plans, there are also 403(b) plans for employees of public schools and certain tax-exempt organizations, and certain ministers and 457 plans for

invested in securities like mutual funds, and the savings accumulated over the working life of the employee, along with returns on the investment, are paid to the participant, usually in a lump sum, after retirement.<sup>58</sup>

### B. Influence of ERISA Changes

Regulatory and social influences over the several decades since the enactment of ERISA contributed to the proliferation of defined contribution plans.<sup>59</sup> A main source of regulatory influence came from ERISA, both as originally conceived and through the almost forty amendments to it since 1974.<sup>60</sup> Four key structural changes to ERISA started the trend toward the defined contribution society that we have today.<sup>61</sup> These changes include (1) the creation of the individual retirement account (IRA), (2) the heavier regulatory burden imposed on defined benefit plans, (3) reduced fiduciary standards for self-directed accounts, and (4) relaxed company stock holding rules in defined contribution plans.<sup>62</sup> Each of these factors is discussed in more detail below. These four factors created three direct consequences that are the building blocks of my argument. The first is that these changes set in motion the decline of the defined benefit and the rise of the defined contribution plan. The second is that self-directed plans, like the 401(k), became the dominant retirement vehicle, based in part on the successful model provided by IRAs. Third, participants in self-directed accounts rely heavily upon mutual and index funds as investment options thus increasing their market significance and the number of indirect investors.

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“certain state and local governments and non-governmental entities tax exempt under IRC 501.” 403(b) *Plan Basics*, *supra* note 4; IRC 457(b) *Deferred Compensation Plans*, *supra* note 4.

58. KOZAK, *supra* note 4, at 86. The lump-sum distributions are generally rolled over into self-directed IRA accounts or annuities to provide income distributions over retirement. See, e.g., Sumit Agarwal et al., *The Age of Reason: Financial Decisions over the Life Cycle and Implications for Regulations*, BROOKINGS PAPERS ON ECON. ACTIVITY, Fall 2009, at 51, 53–54, 85 (discussing the common practice of rolling over retirement benefits into a private IRA).

59. In addition to the factors discussed in this Part, other contributing factors to the decline in the defined benefit plan are the decline of unions and the manufacturing industry. “[A] good predictor of whether a firm sponsors a defined benefit plan is whether it has a collective bargaining agreement. Another good predictor of defined benefit sponsorship (often overlapping with union membership) is whether the firm is engaged in traditional manufacturing or extractive activity.” Zelinsky, *supra* note 5, at 480.

60. KOZAK, *supra* note 4, at 35–37; JOHN H. LANGBEIN, DAVID A. PRATT & SUSAN J. STABILE, *PENSION AND EMPLOYEE BENEFIT LAW* 98–104 (2010) (describing forty-three post-1974 amendments and enactments that have affected ERISA’s scope).

61. Zelinsky, *supra* note 5, at 471.

62. *Id.* at 471–72.

From these three consequences the citizen shareholders and the defined contribution society were born.

1. *Regulatory Burdens in Defined Benefit Plans.* The restrictive regulatory environment of defined benefit plans spurred growth of the current defined contribution society.<sup>63</sup> Regulatory burdens on defined benefit plans unintentionally created incentives for employer sponsors to shift from defined benefit plans to defined contribution plans to avoid the additional costs and liabilities associated with pension funding responsibilities.<sup>64</sup> The regulatory burden of plan administration and financing was “particularly pronounced for small plans; over the period of 1981–96 administrative costs as a percentage of payroll nearly tripled for defined benefit plans . . . .”<sup>65</sup> Regulatory burdens imposed on defined benefit plans, but not defined contribution plans, include: (a) minimum funding requirements, (b) mandatory vesting standards, (c) contributions to the Pension Benefit Guaranty Corporation (PBGC), and (d) extensive fiduciary duties on trustees managing plan assets.<sup>66</sup> These requirements reduced employer flexibility in managing defined benefit plans—flexibility that remains available with defined contribution plans.<sup>67</sup>

The difference in regulatory burdens between defined benefit and defined contribution plans exemplifies the fundamental difference between these two types of retirement savings systems. Defined benefit plan regulations are concerned primarily with outputs—payments to retirees—which fall exclusively on the employer sponsor; thus, employers sponsoring defined benefit plans are more heavily regulated under ERISA.<sup>68</sup> The defined benefit system placed complete control over retirement income with employer sponsors and therefore ERISA

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63. See WOOTEN, *supra* note 38, at 278–79.

64. Gelter, *supra* note 20, at 936 (“The transformation of the American pension system came about not through deliberate planning, but largely as an unintended consequence of regulation that was primarily intended to protect workers.”). “ERISA imposed minimum standards for participation, vesting, and funding that were particularly stiff for defined benefit plans.” MUNNELL & SUNDÉN, *supra* note 6, at 26.

65. MUNNELL & SUNDÉN, *supra* note 6, at 27.

66. Gelter, *supra* note 20, at 929–30.

67. “These often opaque rules limit (and frequently eliminate) any employer flexibility in the financing of defined benefit plans.” Zelinsky, *supra* note 5, at 475. Funding minimums, vesting requirements and contributions to the Pension Benefit Guaranty Corporation (PBGC) are discussed in this Part and fiduciary standards are discussed separately in Part V.

68. KOZAK, *supra* note 4, at 86 (“Current defined benefit plans generally are funded exclusively with employer contributions . . . .”).



coupled that responsibility with additional regulatory oversight.<sup>69</sup> Additionally, nearly annual legislative amendments, agency regulations, and advisory opinions increased the costs of implementing and complying with regulations of defined benefit plans.<sup>70</sup> Defined contribution plan regulations, on the other hand, focus on inputs since the benefit that is paid is comprised entirely of the accumulation of contributions and returns on investment, minus administrative costs.<sup>71</sup> Additionally, participants in defined contribution plans bear most of the costs and the risks of the investments whereas employer sponsors bear the costs and the risks with defined benefit plans.<sup>72</sup>

Minimum funding requirements for defined benefit plans serve the fundamental function of ERISA—to ensure delivery of promised benefits.<sup>73</sup> Employers typically fund defined benefit plans by annual contributions based upon the number of employees, the amount of benefits to be paid, and the age of participants.<sup>74</sup> Fiduciaries typically invest those pension funds in annuities, stocks, mutual funds, bonds, or some combination thereof.<sup>75</sup> Funding defined benefit plans is a complex endeavor and subject to many factors outside of the employer sponsor's control, such as large market losses.<sup>76</sup> As a result, employer sponsors are annually required to hire a private sector Enrolled Actuary<sup>77</sup> who recommends the annual required contribution

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69. *Id.* at 35–37, 79–80.

70. MUNNELL & SUNDÉN, *supra* note 6, at 26 (discussing the frequent legislative developments and new defined benefit regulations that result in a complex and costly regulatory environment); *see also* KOZAK, *supra* note 4, at 35–37 (discussing the numerous amendments that have been made to ERISA since enactment).

71. KOZAK, *supra* note 4, at 86 (“The defined contribution model deals exclusively with inputs . . .”).

72. MUNNELL & SUNDÉN, *supra* note 6, at 26 (discussing the frequent legislative developments and new defined benefit regulations that result in a complex and costly regulatory environment); *see infra* Part IV; *see also* KOZAK, *supra* note 4, at 80 (discussing the shift of investment risk in defined contribution versus defined benefit plans).

73. Some defined contribution plans, like money purchase plans and target benefit plans, are subject to minimum funding rules under ERISA because the employer promises to contribute a fixed percentage of compensation. Borzi, *supra* note 4, at A-17.

74. *See, e.g., Pension Funding Guidelines*, GOVERNMENTAL ACCOUNTING STANDARDS BD., [www.nga.org/files/live/sites/NGA/files/pdf/1209PensionGuidelines.pdf](http://www.nga.org/files/live/sites/NGA/files/pdf/1209PensionGuidelines.pdf) (last visited Sept. 20, 2013); *see also* KOZAK, *supra* note 4, at 113–14 (discussing the information actuaries take into consideration in determining whether a plan is properly funded).

75. *See Private Pension Plan Bulletin: Abstract of 2010 Form 5500 Annual Reports*, *supra* note 11, at 29, 31 (listing the distribution of assets in defined benefit plans).

76. *See* KOZAK, *supra* note 4, at 112.

77. 29 U.S.C. § 1023(a)(4)(A) (2006). “An Enrolled Actuary is any individual who has satisfied the standards and qualifications as set forth in the regulations of the Joint Board for the Enrollment of Actuaries as amended, and who has been approved by the Joint Board to perform actuarial services required under the Employee Retirement Income Security Act of 1974 (ERISA).” *Enrolled Actuary Information*, IRS,

based upon the current value of the plan assets and future liabilities in relation to current market trends.<sup>78</sup> Inaccurate funding estimates that result in insufficiently funded plans require immediate deposits to cover all liability, and overfunded plans yield steep penalty taxes on the excess funds.<sup>79</sup>

Employers' annual contribution requirements depend in part on market performance. For example, in a rising market the anticipated annual contribution may be offset by returns, or in a falling market, losses may increase the estimated contribution.<sup>80</sup> As a result, employers have difficulty accurately planning for annual contribution needs. The volatility of the recommended annual contribution affects an employer's bottom line as well as financial statements and reports to investors.<sup>81</sup> Consider, for example, the dramatic decline of the stock market in 2008, which resulted in additional contribution burdens and decreased profits for many employer sponsors. Defined contribution plans do not contain similar funding requirements or penalties since the employer only facilitates employees' contributions.<sup>82</sup> Under self-directed defined contribution plans, the employee bears the risk of market loss because only the employee is responsible for ensuring that the retirement account is adequately funded, not the employer.<sup>83</sup> By shifting these risks onto employee participants in defined contribution plans, employers avoid the uncertainty of funding obligations and related balance-sheet adjustments.

Required contributions to the PBGC<sup>84</sup> are another unique burden imposed on nearly all defined benefit plans.<sup>85</sup> The PBGC

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<http://www.irs.gov/Tax-Professionals/Enrolled-Actuaries/Enrolled-Actuary-Information> (last updated Apr. 15, 2013).

78. KOZAK, *supra* note 4, at 112–13. Enrolled Actuary assumptions include: mortality of the participants, interest and fund earnings, disability rates of participants, withdrawal rates of participants, future employment rates, increasing age of retirement, benefit payment options, dependent or marital status of participants, salary scale and the likelihood of disastrous or cyclical events affecting the employer's industry. *Id.* at 113–14.

79. *Id.* at 112 (discussing funding inadequacy penalties and tax rates for excessive funding of defined benefit plans).

80. *See id.* at 86 (noting that with defined benefit plans, "the risk of large investment losses remains with the employer, since lower-than-expected returns or losses will simply mean that the employer will need to make larger contributions").

81. *Id.* ("Because of the required actuarial valuation, the funding requirements are sometimes quite volatile from year to year, which not only impacts the actual contribution required by the employer, but also can impact the business financial statements.").

82. *Id.* at 109, 111 (discussing the funding requirements for employer sponsors with defined contribution plans).

83. For a complete discussion of market performance risks, see Part IV.A.

84. KOZAK, *supra* note 4, at 426. "Under Title IV [of ERISA], certain employers and plan administrators must fund an insurance system to protect certain kinds of retirement benefits, with premiums paid to the federal government's [PBGC]." *Id.*

85. Getler, *supra* note 20, at 930.

bears the risk of a loss of plan assets and employer sponsor assets.<sup>86</sup> “Insofar as the participant’s pension claim is insured by the PBGC, the participant . . . has recourse to the PBGC if the employer-issuer becomes insolvent and the collateral (i.e., the pension trust assets) becomes inadequate.”<sup>87</sup> In the defined benefit framework, ERISA imposes obligations on employer sponsors to both ensure adequate fund planning through the minimum requirements as well as to the payment of insurance premiums to the PBGC to ensure employee recourse in the event of a plan default.<sup>88</sup> There are no similar requirements with defined contribution plans and notably no such protections for inadequate retirement account funding by individuals since the burden to adequately fund retirement savings falls exclusively on the employee.<sup>89</sup>

Shifting the funding responsibility to employees under defined contribution plans and eliminating the PBGC safety net removed many of the regulatory burdens imposed on defined benefit plans.<sup>90</sup> The different regulatory burdens between defined benefit and defined contribution plans facilitated the decline in pension plans and the rise of 401(k)s, creating the first development crucial in establishing the defined contribution society.<sup>91</sup>

2. *Birth of the Self-Directed Plan—The IRA.* The second step in establishing the defined contribution society was the introduction of self-directed accounts. ERISA attempted to address, among other issues, restrictions on and complications

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86. Zelinsky, *supra* note 5, at 465–66. The PBGC was created:

(1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants, (2) to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under plans to which this subchapter applies, and (3) to maintain premiums established by the corporation under section 1306 of this title at the lowest level consistent with carrying out its obligations under this subchapter.

29 U.S.C. § 1302 (2006).

87. Zelinsky, *supra* note 5, at 466.

88. KOZAK, *supra* note 4, at 426. “[L]egal rules that promote security and clarity may render benefit promises more costly; in other words, rules may have both desirable and undesirable consequences . . .” Brendan S. Maher & Peter K. Stris, *ERISA & Uncertainty*, 88 WASH. U. L. REV. 433, 435 (2010).

89. See, e.g., Steven Wilhelm, *Why Boeing’s Fighting to Retire Union*, PUGET SOUND BUS. J. 1–2 (Jan. 11, 2013, 10:43 AM), <http://www.bizjournals.com/seattle/news/2013/01/10/boeing-union-showdown-looms-on.html?page=all> (describing the labor dispute between Boeing and its engineers over the proposal elimination of defined benefit for a 401(k) plan in light of rising and uncertain retirement costs imposed upon Boeing).

90. See *supra* Part II.A–B.1.

91. See *supra* Part II.A–B.1.

of workers' mobility.<sup>92</sup> Defined benefit plans, such as pensions, often had long vesting requirements where an employee would not receive benefits until after she had worked a significant number of years for the company, which stifled job mobility.<sup>93</sup> Additionally, the payment structure for vested benefits after termination of employment created undesirable burdens on employers<sup>94</sup> and tax consequences for employees.<sup>95</sup> "Congress created the first, or traditional, IRA to have two roles: (1) to give workers without retirement plan coverage at work a tax-advantaged means to save for retirement, and (2) to preserve employer-sponsored plan assets by allowing them to be rolled over into IRAs at job change or retirement."<sup>96</sup> Originally authorized by ERISA in 1974, contributions to IRAs were tax deductible for those workers who were not covered by an employer-sponsored plan. The Economic Recovery Tax Act of 1981 expanded the applicability of IRAs by allowing all individuals, whether or not covered by an employer's plan, to

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92. MUNNELL & SUNDÉN, *supra* note 6, at 40–44 (describing the negative effects of job shifting on retirement income in traditional defined benefit plans).

93. *See id.* at 40 (comparing the retirement fund benefits associated with remaining at one job for long periods of time versus changing jobs).

94. Zelinsky, *supra* note 5, at 458, 461–67 (explaining the taxes and potential risks employers associated with defined benefit plans).

[Drafters of ERISA] addressed the situation of the vested but younger participant who leaves employment prior to his retirement age. Under pre-ERISA practice, it was common . . . for the (now-terminated) employee to receive nothing at the time he severed employment. Rather, he remained entitled to a deferred benefit, payable on a delayed basis . . . . For both administrative and economic reasons, this delay was often problematic, particularly as to relatively young employees. As an administrative matter, the plan and the terminated participant had to stay in touch with one another for the participant to receive information about the plan and his benefit and, ultimately, for the participant to get paid. Such participant tracking could be (and still is) resource consuming.

*Id.* at 472.

95. *Id.* at 473 ("While this early taxation often occurred at relatively favorable rates such early taxation was (often correctly) viewed as diminishing the ultimate resources available for the participant's retirement.").

96. Sarah Holden et al., *The Individual Retirement Account at Age 30: A Retrospective*, 11 PERSPECTIVE 1, 4 (2005), available at <http://www.ici.org/pdf/per11-01.pdf>.

IRAs were designed with two goals when they were created in 1974 under the Employee Retirement Income Security Act (ERISA). First, they provide individuals not covered by workplace retirement plans with an opportunity to save for retirement on a tax-advantaged basis on their own. Second, they allow workers who are leaving jobs a means to preserve the tax benefits and growth opportunities that employer-sponsored retirement plans provide.

INV. CO. INST., *supra* note 2, at 125.

make tax deductible contributions to their accounts.<sup>97</sup>

With an IRA, employees could transfer a pre-retirement distribution from a qualified plan through a “rollover” to an IRA.<sup>98</sup> Money rolled over in the IRA account grew tax-free until the time of withdrawal, which usually occurs at retirement.<sup>99</sup> Rollover rules were expanded so that monies could be transferred from one qualified employer plan to another qualified employer plan (consolidated rollover).<sup>100</sup> For example, if a young associate leaves law firm X, she may roll over her benefits to a qualified defined contribution plan of law firm Y, or to an IRA where it could grow tax-free until retirement. The rollover feature even facilitated converting some monies that began as defined benefit pension investments into monies invested in an individual IRA or another employer’s qualified defined contribution plan.<sup>101</sup> Both the increasing mobility of American workers<sup>102</sup> and the consequences of such mobility (converting defined benefit monies into defined contribution or IRA monies) contributed to the rise of self-directed plans.<sup>103</sup> “Traditional IRAs—defined as those IRAs first allowed under ERISA—were the most common type of IRA, owned by 39 million U.S. households [as of mid-2012],” fueled primarily by rollovers.<sup>104</sup> The IRA was not just a solution for mobile employees; it became an important tax-deferred savings vehicle for individuals investing in and outside of employer-

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97. STAFF OF THE JOINT COMM. ON TAX’N, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 197–98 (Comm. Print 1981), available at <https://www.jct.gov/publications.html?func=startdown&id=2397> (detailing the purposes, reasoning, and changes of the Economic Recovery Tax Act); Kelly Phillips Erb, *Deduct This: History of the IRA Deduction*, FORBES (June 27, 2011), <http://www.forbes.com/sites/kellyphillipserb/2011/06/27/deduct-this-history-of-the-ira-deduction/> (describing the history and evolution of the IRA); *The Evolving Role of IRAs in U.S. Retirement Planning*, ICI RES. PERSP. 1, 3, 5 (Nov. 2009), available at <http://www.ici.org/pdf/per15-03.pdf> (describing the creation of IRAs in 1974 with ERISA and later developments with the Economic Recovery Tax Act).

98. Zelinsky, *supra* note 5, at 473–74.

99. *Id.* at 474.

100. *Rollover IRAs*, PERSHING 1–2 (2011), available at [http://www.pershing.com/factsheets/rollover\\_ira\\_fact\\_sheet.pdf](http://www.pershing.com/factsheets/rollover_ira_fact_sheet.pdf) (illustrating an array of options available to employees with IRAs, including the option to rollover funds from one employer plan to another).

101. Zelinsky, *supra* note 5, at 474 (“Thus, over time, pension based wealth was destined to migrate from employer-sponsored plans to the IRAs of former employees”).

102. MUNNELL & SUNDÉN, *supra* note 6, at 42–43 (addressing conflicting scholarly views and studies concerning the increasing mobility of American workers).

103. *Id.* at 40–42 (discussing job mobility and negative consequences with respect to defined benefit plans and compatibility with defined contribution plans).

104. INV. CO. INST., *supra* note 2, at 126–27 (showing the growing prevalence of traditional IRAs after their creation under ERISA).

sponsored plans.<sup>105</sup> Congress created several different variations of the IRA—the Roth IRA, the Health Savings Account, and the Education IRA—to encourage individual savings.<sup>106</sup>

The tax incentives proved attractive to Americans and participation in these plans grew. IRAs familiarized many investors with the model of private securities investments for long-term savings goals and built examples of success, which created both acceptance of and appetite for self-directed retirement accounts.<sup>107</sup> In 2012, IRA assets totaled \$5.4 trillion and accounted for 28% of all retirement assets in the United States.<sup>108</sup> The largest component of IRAs are mutual fund assets, totaling \$2.5 trillion in 2012, followed closely by individual brokerage accounts with \$2.1 trillion in assets.<sup>109</sup> IRAs are not defined contribution plans, but they introduced American workers to self-directed accounts and dependence upon indirect ownership through mutual funds for long-term savings goals.<sup>110</sup> In establishing a successful model of self-

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105. Zelinsky, *supra* note 5, at 474 (“Roth IRAs, first made available in 1998 under the Taxpayer Relief Act of 1997, were owned by almost 19 million U.S. households in mid-2011. Nearly 9 million U.S. households owned employer-sponsored IRAs (SEP IRAs, SAR-SEP IRAs, or SIMPLE IRAs).”). As of May 2012, these numbers have increased slightly, with 20.3 million U.S. households owning Roth IRAs and 9.2 million households owning employer-sponsored IRAs. INV. CO. INST., *supra* note 2, at 126.

Congress created the Simplified Employee Pension (SEP) IRA in the Revenue Act of 1978 because of concern [regulations were] preventing small employers from offering retirement plans to their workers. . . . More recently, in the Small Business Job Protection Act of 1996, Congress created the Savings Incentive Match Plan for Employees, or SIMPLE, IRA, specifically for employers with 100 or fewer employees.

Holden et al., *supra* note 96, at 8 (detailing various versions of the IRA created to spread the benefits to all employees).

106. I.R.C. §§ 408–408A, 529–530 (2006); *see also* Medill, *supra* note 33, at 327–28. ROTH IRAs were established in the Taxpayer Relief Act of 1997. “Contributions to Roth IRAs are not deductible from current income, but investment earnings may generally be withdrawn tax free (features that Congress felt might be appealing to some taxpayers). In addition, the Roth IRA does not have a minimum distribution requirement and contributions are allowed after age 70½.” Holden et al., *supra* note 96, at 9 (discussing the creation of the Roth IRA and the advantages it created under the Taxpayer Relief Act).

107. Zelinsky, *supra* note 5, at 474–75 (acknowledging that successful experiences with IRAs led to their increased utilization in America); *see also* Gelter, *supra* note 20, at 16–18.

108. INV. CO. INST., *supra* note 2, at 125 (analyzing the evolution of IRA use after its creation).

109. *Id.*

IRA owners are more likely to hold mutual funds, especially long-term mutual funds, in their IRA portfolios than any other type of investment. Sixty-eight percent of IRA-owning households had IRA assets invested in mutual funds. About four out of five of these households, or 54 percent of all IRA-owning households, held at least a portion of their balance in equity mutual funds.

*Id.* at 120 (citation omitted).

110. Zelinsky, *supra* note 5, at 470–71.

directed retirement accounts, IRAs were an important benchmark in the evolution of defined contribution plans and widespread acceptance of self-directed retirement accounts.<sup>111</sup> Additionally, IRAs marked the beginning of dependence of American workers on private securities markets, particularly mutual and index funds, as key investment vehicles for long-term savings goals.<sup>112</sup>

### 3. *Reduced Employer Fiduciary Duty for Self-Directed Plans.*

Perhaps the most attractive incentive for employers to create self-directed defined contribution plans is the relationship between self-directed accounts (when the employee chooses the investment allocations) and the reduction of employer fiduciary duties. Employers sponsoring defined benefit plans must comply with a list of fiduciary duties owed to the plan and plan participants, violation of which exposes the employer, and other designated actors, to personal liability for plan losses.<sup>113</sup> In contrast, employers (and designated actors) are largely immunized, under section 404(c) of ERISA, against liability for investment losses resulting from participants' choices in the self-directed accounts regardless of whether fiduciary duties were breached.<sup>114</sup>

The consequences of reduced fiduciary duty liability are discussed in further detail in Part V. To advance the present

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111. See *id.* at 469–71 (noting that IRAs “played a critical role in acclimating Americans to the notion of tax-advantaged individual accounts”).

112. Gelter, *supra* note 20, at 17 (noting that employers funding defined benefit pension plans typically invest funds for the plan in securities markets, commonly in mutual, index, and other indirect investment vehicles); Usha Rodrigues, *Corporate Governance in an Age of Separation of Ownership from Ownership*, 95 MINN. L. REV. 1822, 1830 (2011). Pension funds are a form of institutional investor and wield significant market power. See generally INV. CO. INST., *supra* note 2, at 11, 39, 108 (describing pension plans as investors in the markets and describing asset holdings).

113. Capobianco & Jara, *supra* note 49, at \*2–5.

A fiduciary may be expressly named in the plan documents or designated as such by the board of directors of the plan's sponsor. However, the statute does not limit the scope of fiduciary status to those who are expressly given the label. . . . [C]ourts [must] determine who is performing—or has the authority to perform—the discretionary functions that give rise to fiduciary status. Accordingly, if a person exercises or has any discretionary authority or control over plan administration or assets, that person will likely be a *de facto* ERISA fiduciary charged with the same responsibilities and subject to the same liabilities as any expressly identified fiduciary. The ERISA's test is fact-intensive and must be construed broadly in order to effectuate the ERISA's purposes.

*Id.* at \*2.

114. Gelter, *supra* note 20, at 17. “ERISA encouraged the creation of ‘participant-directed’ DC plans because the employer or other persons designated as or deemed to be fiduciaries are not liable for investment losses that result from the beneficiaries’ choices.” *Id.*

argument, it is sufficient to note that the difference in the liability structure between defined benefit and contribution plans created another incentive for employers to offer defined contribution plans as opposed to defined benefit plans and to make those plans self-directed.<sup>115</sup> These incentives contributed to the growth of the defined contribution society we have today.

4. *Additional Regulatory Incentives for Defined Contribution Plans.* In addition to the fundamental regulatory differences between defined benefit and defined contribution plans, ERISA creates several additional incentives for employers to offer or convert pension plans to the defined contribution model. Overfunded defined benefit plans, where employers continued making aggressive contributions to the plan even in strong market years, became a source of cash for the corporation or a potential acquirer. Terminating a defined benefit plan and recasting it as a defined contribution plan allows employer sponsors to recapture the overinvested assets dedicated to the pension plan.<sup>116</sup> The potential cash assets in overfunded pension plans made the employer sponsors potential targets for hostile takeovers.<sup>117</sup> Compare this with defined contribution plans, which can be a useful corporate deterrent against hostile take-overs.<sup>118</sup> Defined contribution plan rules allow employers to offer their own stock to employee participants as a part of an ESOP,<sup>119</sup> and

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115. *Id.* at 19.

Firms used the opportunity to terminate DB plans and create DC plans instead, while taking the excess value of the plan assets (over the net present value of the pension payments) into corporate profits. Legally, plan terminations were made possible by a 1983 ruling by the IRS (encouraged by the Department of Labor), which clarified that plan terminations were not only permissible in narrow cases of 'business necessity,' but generally as long as the employer bought an annuity for the existing benefits from an insurance company.

*Id.*

116. *Id.*; see MUNNELL & SUNDÉN, *supra* note 6, at 27. IRS code amendments in the late 1980s tried to "protect plans from terminations by imposing a reversion tax. However, the long-term effect was to make DB plans even more unattractive to employers, who reacted by reducing the target funding ratios and ultimately by converting DB plans into cash balance plans, which allowed them to avoid the tax penalty." Gelter, *supra* note 20, at 20.

117. MUNNELL & SUNDÉN, *supra* note 6, at 27 (recognizing that overfunded pension plans created a balance sheet asset that made companies takeover targets, especially after the plan termination rules allowed it).

118. Gelter, *supra* note 20, at 31 n.189, 35 (tracing the changing environment towards hostile takeovers and their effect on the growth of defined contribution plans).

119. José Martin Jara, *What Is the Correct Standard of Prudence in Employer Stock Cases?*, 45 J. MARSHALL L. REV. 541, 548 (2012). "To qualify as an ESOP, the plan must be 'designed to invest primarily in employer stock.'" *Id.*

[Defined contribution plans] would supplant defined-benefit pension plans as the primary source of employee retirement income. Hence Congress did



that stock can be voted with management to fend off a hostile takeover.<sup>120</sup> Where defined benefit plans made an employer sponsor a hostile takeover target, defined contribution plans could be a shield against such takeovers. Finally, employers are better able to shift administrative costs of employee participants under defined contribution rather than defined benefit plans creating additional incentives with the defined contribution, rather than the defined benefit, model.<sup>121</sup>

The difference in the regulatory framework between defined benefit and defined contribution plans provided incentives for employers to offer defined contribution plans over defined benefit plans.<sup>122</sup> The result is best described by Professor Zelinsky as

a quiet, largely unheralded revolution, a revolution it has been, incrementally but fundamentally changing the manner in which Americans think about tax and social policy and in which their governments formulate such policy. Like any other paradigm shift, the emergence of the *defined contribution society* has both opened opportunities and foreclosed possibilities.<sup>123</sup>

The incentives to convert defined benefit plans into defined contribution plans along with the development of IRAs gave rise to the second trend—the evolution of defined contribution plans and the acceptance of self-directed defined contribution plans where employees bore market risks and employers enjoyed reduced fiduciary duties.<sup>124</sup> Additionally, with the rise of self-directed defined contribution plans came the corresponding dependence of participants on private securities markets, particularly in the form of mutual and index funds.<sup>125</sup>

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not extend the 10 percent limit on employer stock holdings to 401(k) plans. Employers thus have much latitude in determining how much employer stock employees may hold in their 401(k).

James J. Choi, David Laibson & Brigitte C. Madrian, *Are Empowerment and Education Enough? Underdiversification in 401(k) Plans*, BROOKINGS PAPERS ON ECON. ACTIVITY, 2005, No. 2, at 151, 155.

120. See, e.g., 29 C.F.R. § 2509.94-2 (2008) (discussing the responsibilities of fiduciaries, especially within the proxy voting role).

121. See *infra* Part V.

122. Zelinsky, *supra* note 5, at 475–77.

123. *Id.* at 454 (emphasis added).

124. *Id.* at 474–77.

125. INV. CO. INST., *supra* note 2, at 128; Rodrigues, *supra* note 112, at 1830.

### III. CITIZEN SHAREHOLDERS AND THE ALIENATION FROM CORPORATE LAW

The emerging defined contribution society created a unique class of investors—the citizen shareholder who predominantly invests in mutual or index funds.<sup>126</sup> These investors, however, do not fit neatly within the traditional corporate law framework, which balances shareholder accountability with management authority.<sup>127</sup> Nor do the reporting and disclosure requirements under securities regulations reach citizen shareholders in a meaningful way.<sup>128</sup> As discussed above in Part III, ERISA's original purpose of securing defined benefit plans created a system of reduced fiduciary standards and regulatory oversight for defined contribution plans.<sup>129</sup> Many of the intended protections of traditional corporate law, securities regulations, and the original ERISA framework do not fully extend to citizen shareholders invested through defined contribution plans.<sup>130</sup> The following Part briefly outlines the unique attributes of defined contribution investors and summarizes the resulting incompatibilities with corporate and securities law, which are discussed in more detail in a separate article.<sup>131</sup>

The rise of the defined contribution society and the dependence on self-directed investment accounts resulted in an increasing number of Americans invested in the stock market as their primary form of retirement savings.<sup>132</sup> While there are individual differences among many investors (i.e., priority, time horizon, risk tolerance, level of diversification), citizen

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126. Tucker, *supra* note 15, at 1308.

127. *Id.* at 1310, 1324–25.

128. The 1933 Securities Act focuses on issuance of securities from the issuing company and sold directly to shareholders. *See, e.g.*, Roberta S. Karmel, *Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission is Appropriate?*, 80 NOTRE DAME L. REV. 909, 912 935–39 (2005) (explaining the events that led to the creation of the various securities laws and the Securities Exchange Commission). These sales and their required disclosure and registration requirements are outside of the typical investment vehicle utilized by citizen shareholders. Rodrigues, *supra* note 112, at 1828–29. The 1934 Securities Act focuses primarily on the secondary market and the related required disclosures, as well as proxy access. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 526, 532 (1990). The disclosures and the proxy access rights are exercised by direct shareholders, not indirect shareholders. Tucker, *supra* note 15, at 1300–02, 1321. The observations stated in this Part regarding the limited applicability these direct shareholder mechanisms have on indirect owners are consistent with the limitations of corporate governance mechanisms described herein.

129. *See supra* Part II.

130. Tucker, *supra* note 15, at 1309, 1316, 1324.

131. Tucker, *supra* note 34.

132. INV. CO. INST., *supra* note 2, at 94.

shareholders have commonalities in how they enter the market,<sup>133</sup> their investment in indirect funds, and a rational preference for long-term growth to fund future retirement.<sup>134</sup> That citizen shareholders are indirect shareholders is a consequence of the relationship between the rise of self-directed defined contribution accounts and the resulting dependence upon mutual and index funds as a primary investment vehicle for these plans.

Indirect shareholders have a complicated status in corporate law. They have indirect voting and information rights meaning that they get information and voting rights only through the fund in which they are invested, not in the operating companies in which the fund is invested.<sup>135</sup> Indirect shareholders own stock in a mutual or index fund; the mutual or index fund in turn invests in hundreds of operating companies including, for example, Coca-Cola. The mutual fund, as the direct shareholder, votes in annual director elections as well as various proxy proposals and end-of-company life decisions, such as whether or not to approve a merger.<sup>136</sup> Direct shareholders also receive annual operating company information before voting and, when dissatisfied with the company performance or policy, can exit by selling shares on the market and investing in a suitable alternative.<sup>137</sup>

Indirect owners, however, have diluted rights as compared to the direct shareholder. Indirect stock ownership distorts traditional rights held by direct shareholders such as voting, disclosure, and exit rights in operating companies. Indirect investors receive information about the intermediary mutual fund and vote in fund elections but do not receive information or voting rights from Coca-Cola or the other operating companies in

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133. Tucker, *supra* note 15, at 1313–14 (describing how employer-sponsored defined contribution plans are a common entry point for investors into the securities markets with 72% of first-time mutual fund purchases after 2005 occurring within defined contribution plans).

134. *Id.* at 1317–21 (describing citizen shareholders' rational preference for market performance rather than company-specific performance given their diversification and long-term savings goals); see also Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 583–85 (2006) (discussing the role of market performance with diversified portfolios and the concept of the universal investor); cf. LYNN STOUT, *THE SHAREHOLDER VALUE MYTH* 8–9, 69–70 (2012) (discussing shareholder heterogeneity).

135. Tucker, *supra* note 15, at 1322–24.

136. See Exchange Act § 14, 15 U.S.C. § 78n (1988) (requiring mutual funds to follow guidelines when “giving a proxy, consent, or authorization in respect of any security”); 17 C.F.R. §§ 240.14a-1–240.14b-2 (1990); 17 C.F.R. § 240.14a-101 (1990) (enumerating the rules under which proxy agreements must be undertaken); see also MARK SARGENT & DENNIS HONABACH, *PROXY RULES HANDBOOK*, § 2:12 (2011) (describing proxy voting rules); Black, *supra* note 128, at 536–41 (describing shareholder notice and voting rules).

137. Tucker, *supra* note 15, at 1310, 1323–24.

which the fund is invested.<sup>138</sup> “[T]he corporation’s vote holder is not the ultimate beneficial owner of the corporation, but instead an intermediary that enables the investor to own an interest in a mix of shares packaged as a unitary investment vehicle.”<sup>139</sup>

Regarding disclosures that reach indirect investors through intermediaries, research suggests that inundation of disclosures decreases the effectiveness of disclosed information because of competing noise.<sup>140</sup> Additionally, the rational apathy of shareholders, particularly indirect owners, makes corporate reforms to increase shareholder accountability like say-on-pay symbolic, but ineffective, tools to give indirect shareholders meaningful participation rights in corporate governance.<sup>141</sup> The diluted information rights of indirect owners also affect exit rights—where the choice to leave is prompted by timely and accurate information, which indirect owners do not receive. Additionally, indirect owners cannot sell just their indirect interest in one operating company, but they must sell their interest in the entire fund.<sup>142</sup>

Indirect shareholders are distanced from many power-balancing mechanisms in corporate law and securities disclosures intended to protect shareholder interests. Instead, they must rely on the intermediary, like a mutual fund, to adequately represent and protect their interests.<sup>143</sup> Intermediaries, often in the form of

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138. See, e.g., Black, *supra* note 128, at 523–24, 536–37 (describing direct shareholder notice and voting rules); Taub, *supra* note 32, at 851 (“[Mutual fund participants] take[] the economic risk, but [they are] not the legal owner of the mutual fund or the underlying portfolio companies. In this way, [the investors are] distanced even more from the location of control over the capital [they have] at risk.”); see also Tucker, *supra* note 15, 1323–24, 1327–28 (comparing direct and indirect shareholders’ voting and information rights).

139. Rodrigues, *supra* note 112, at 1828–29.

140. *Id.* at 1853–55 (describing disclosures as failures because additional disclosures are “noisy” and “easy for investors to ignore” and offer little by the way of tangible result).

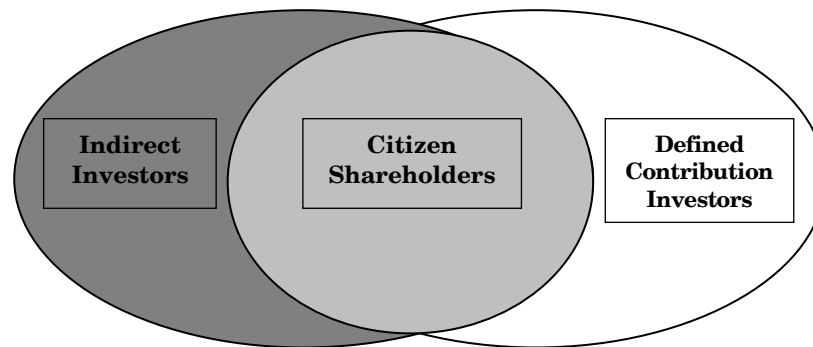
141. See Black, *supra* note 128, at 523–24 (discussing indirect shareholder passivity).

142. Tucker, *supra* note 15, at 1328.

143. See, e.g., William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1409 (2006) (arguing that the mutual fund “industry’s faults can be found in the idiosyncratic structure of mutual funds, a structure that exacerbates the ability of managers to wield substantial power and to use that power to extract rents both overtly and surreptitiously from shareholders”); Katharine V. Jackson, *Towards a Stakeholder-Shareholder Theory of Corporate Governance: A Comparative Analysis*, 7 HASTINGS BUS. L.J. 309, 322–23 (2011) (describing the power of mutual fund managers due to the size of votes they represent).

Interestingly, mutual funds . . . have been described as ‘relatively docile shareholders’ because they rarely engage in activism. . . . Some observers have criticized possible conflicts of interest of mutual fund managers. Arguably they are sometimes inclined to please corporate managers, who are in the position to direct employees’ 401(k) wealth to investment companies that do not object to the firm’s corporate governance practices. There is some evidence

mutual funds and other institutional shareholders, represent citizen shareholders and other indirect owners. A history of mutual funds' preference for passivity over shareholder activism and consistent support of management proposals are two reasons why the representative capacity of mutual funds is called into question as having misaligned interests with those of its investors.<sup>144</sup> The free rider problem also discourages mutual funds from bearing costs of shareholder activism when they cannot secure the sole benefit for those efforts.<sup>145</sup> Similarly, the hope that other institutional shareholders may incur the costs and take a leadership role is also a powerful disincentive to activism.<sup>146</sup>



that business ties make mutual funds vote in a more manager-friendly way, but it is not unambiguous.

Gelter, *supra* note 20, at 38.

144. James Cotter, Alan Palmiter & Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 VILL. L. REV. 1, 7, 46 (2010) (finding that mutual funds delegate voting decisions to professional proxy services and “consistently” side with management); Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. CORP. L. 265, 295 (2012) (describing problems of short-term and long-term time horizon conflicts); Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1430–31 (2002) (summarizing academic studies concluding that mutual funds are passive investors); Rodrigues, *supra* note 112, at 1830–31 (“[Mutual funds hold] stock in myriad companies and therefore lack the incentive to expend research costs in determining which votes in which particular companies would most increase value. In addition, investments in mutual funds are highly liquid, meaning that a mutual fund investor discontented with a fund’s performance can withdraw her money at any time.”); Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148, 149 (1990) (finding the benefits of long- and short-term arbitrage while also disclosing the risk associated with them). For a comprehensive discussion on noise trading, see Fischer Black, *Noise*, 41 J. FIN. 529, 529–41 (1986) (evaluating both the adverse and beneficial aspects of trading on noise).

145. Roberta Romano, *Institutional Shareholders and Corporate Governance in the US*, in CORPORATE GOVERNANCE IN THE US AND EUROPE: WHERE ARE WE NOW? 55 (Geoffrey Owen et al. eds., 2006) (shedding light on restrictions to shareholder activism); see also Dallas, *supra* note 144, at 270 (discussing the problems managers face when confronted by a lack of information).

146. Fisch, *supra* note 27, at 881–84 (observing the consequences of “slicing and dicing” corporate ownership interests).

Under my definition, citizen shareholders are likely to be indirect, rather than direct, shareholders.<sup>147</sup> The limitations of indirect shareholder status are further exacerbated with citizen shareholders because they have reduced choice in whether or not to invest.<sup>148</sup> Tax incentives, opt-in rules that promote participation in 401(k)s, and the lack of other viable retirement savings alternatives tip the scales in favor of investment and reduce an individual's "choice" as to participation. Second, the menu options of investments within plans—often mutual or index funds along with money market, bonds, or company stock<sup>149</sup>—alter investment choice for citizen shareholders as well. Within the universe of restricted choice, citizen shareholders invest heavily in mutual or index funds, which fuel the growth of indirect shareholders.<sup>150</sup> Limited choice between investment options in the defined contribution menus restrict citizen shareholders' ability to exit.<sup>151</sup> In the contained

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147. Tucker, *supra* note 15, at 1302. "The spread of 401(k) plans contributed to the enormous expansion of the mutual funds industry, where much of these savings are invested." Gelter, *supra* note 20, at 38.

Mutual fund ownership has become so widespread largely because mutual funds are a primary way that Americans save for retirement. Defined-contribution retirement plans and Individual Retirement Accounts often hold mutual funds, and the rapid growth of these plans and accounts has increased mutual funds' total share of retirement assets. Mutual funds now hold approximately a quarter of America's retirement savings.

Molly Mercer, Alan R. Palmiter & Ahmed E. Taha, *Worthless Warnings? Testing the Effectiveness of Disclaimers in Mutual Fund Advertisements*, 7 J. EMPIRICAL LEGAL STUD. 429, 432 (2010) (arguing that mutual funds are the most predominate vehicles for saving for retirement).

148. See Medill, *supra* note 33, at 333 (discussing the role of automatic enrollment and other incentives to participate in defined contribution plans); Cass R. Sunstein, *Empirically Informed Regulation*, 78 U. CHI. L. REV. 1349, 1393 (2011) (describing the consequences of automatic enrollment defaults with defined contribution plans and how they increased participation by altering participants' choice).

149. See, e.g., INV. CO. INST., *supra* note 2, at 117–18 (describing defined contribution asset allocations in equities, funds, company stock, bonds and money market accounts).

150. Tucker, *supra* note 15, at 1322–23 & n.111. An index mutual fund is "[a] fund designed to track the performance of a market index. The fund's portfolio of securities is either a replicate or a representative sample of the designated market index. Often referred to as passively managed portfolios." INV. CO. INST., *supra* note 2, at 226. A mutual fund is

[a]n investment company registered with the SEC that buys a portfolio of securities selected by a professional investment adviser to meet a specified financial goal (investment objective). Mutual funds can have actively managed portfolios, where a professional investment adviser creates a unique mix of investments to meet a particular investment objective, or passively managed portfolios, in which the adviser seeks to track the performance of a selected benchmark or index.

*Id.* at 228.

151. Tucker, *supra* note 15, at 1327.

While others have argued that the fungible nature of mutual funds makes it an

universe of a 401(k) plan offering a limited array of investment options, the indirect owner must find an alternative fund that does not invest in Coca-Cola and offers a similar risk and diversification portfolio.<sup>152</sup> Exit rights are also constrained for citizen shareholders because of the likely absence of a suitable alternative investment within the plan.<sup>153</sup>

Additionally, the question of aligned interests between mutual fund managers and investors is exacerbated by citizen shareholder status. Citizen shareholders who are saving for retirement have a presumed long-term investment horizon and want to achieve sustained growth over a period of time.<sup>154</sup> This long-term time horizon may be in conflict with investment horizons of mutual fund managers where the models of performance evaluation and compensation drive short-term time horizons at the funds.<sup>155</sup> The nature of defined contribution plan structures further complicates the question of aligning interests. Employer sponsors of defined contribution plans are often seen as the “client” of the mutual

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even more liquid asset than investment in an individual company and therefore contains strengthened exit rights, this view does not take into account the realities of how a majority of investors enter and remain in the market.

*Id.*; see John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 88, 102–05 (discussing enhanced exit rights of mutual fund investors who withdraw cash from the fund's assets whereas the sale of direct stock does not affect the assets of the company); see also Strine, *supra* note 15, at 11 (“[S]cholars would say that the ability of mutual fund investors to get their money out at net asset value whenever they want gives them a protection that the stockholders of operating companies do not have. But that retort seems hollow. The net asset value of my mutual fund simply reflects the market value of its investments, most of which are in the stock of publicly traded operating corporations.”).

152. See Tucker, *supra* note 15, at 1329 n.142 (describing investment risk and diversification options within a given defined contribution plan).

153. “[T]he idea that investors have more real choice in mutual fund investments than they have in operating company investments is hardly self-evident.” Strine, *supra* note 15, at 7.

154. See Rodrigues, *supra* note 112, at 1830 (“Actively managed mutual funds attempt to beat the market by investing in stocks that appreciate faster than average.”). But see Shleifer & Vishny, *supra* note 144, at 149 (arguing that making multiple short term arbitrage trades can actually be less risky and lead to more growth than long term trades). In one study, two authors sought to establish the harm of real earnings management relative to accrual earning management by studying the cost of capital. Jeong-Bon Kim & Byungcherl Charlie Sohn, *Real Earnings Management and Cost of Capital*, 32 J. ACCT. & PUB. POL'Y (forthcoming 2013). Their study concluded that real earnings management distorts the role of earnings as an indicator of a firm's true future cash flows and thus exacerbates information problems faced by outside investors to a greater extent than does accrual earnings management. *Id.* (manuscript at 2, 21–22).

155. Taub, *supra* note 32, at 867–72 (2009) (describing in detail conflicts of interests between managers and indirect owners); see also Dallas, *supra* note 144, at 272–73 (describing managers' tactics to increase compensation, bonuses, and performance evaluations based upon short-term performance which may create detrimental long-term effects within the fund and the invested-in companies).

fund and their interests are served over the interests of individual citizen shareholders.<sup>156</sup>

A growing group of Americans are encouraged through tax incentives and automatic enrollment programs to invest in the stock market through defined contribution plans for retirement savings; but once invested, they enjoy a fraction of the investor protections assumed to balance the playing field and help promote and protect nest eggs.<sup>157</sup> Citizen shareholders are not investing in an open market but instead choosing among a limited range of investment vehicles.<sup>158</sup> A worker's decision to invest diverted compensation in one of approximately twenty mutual, index, or bond funds through an automatic-enrollment 401(k) is materially different from an individual investor placing discretionary savings in the market where participation, investment choice and exit are not constrained.<sup>159</sup> The problems of indirect ownership status are intensified with citizen shareholders and raise questions regarding the reach and applicability of corporate governance and securities regulations intended to protect investors.<sup>160</sup>

#### IV. SHIFTING RISKS ONTO CITIZEN SHAREHOLDERS IN THE DEFINED CONTRIBUTION SOCIETY

Citizen shareholders have an additional set of protections outside of the traditional corporate governance mechanisms of voting, information, and exit rights, and securities regulations. Citizen shareholders, because they enter the stock market through employer-sponsored defined contribution plans, have the statutory rights and protections provided under ERISA, which governs employer-provided benefits.<sup>161</sup> This Part discusses how conversion from defined benefit to self-directed defined contribution plans shifts significant risks onto participants, risks which have the potential to undermine individual and national retirement security.

ERISA, enacted in 1974, focused primarily on defined benefit

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156. "[T]he [mutual fund] industry's true customers are not individual investors, but rather portfolio companies that can decide how to allocate their employee-thrift business." Cotter, Palmiter & Thomas, *supra* note 144, at 9.

157. Rodrigues, *supra* note 112, at 1828–29, 1836, 1859–60.

158. Tucker, *supra* note 15, at 1328–29, 1336–40 (describing investment options within a defined contribution plan and describing the mutual funds included in defined contribution plans offered by the three case study companies Wal-Mart, IBM and Well-Point discussed in the article).

159. *Id.* at 1303–04.

160. For a further discussion of these issues, see Tucker, *supra* note 34.

161. See *supra* note 31 (discussing the protections provided under ERISA).



pensions, the most common form of retirement benefits at that time.<sup>162</sup> As previously described, under defined benefit plans, the responsibility of funding and paying retirement benefits to retirees rested solely on the employer.<sup>163</sup> With this responsibility came great risk: risk of bankruptcy and underfunded pensions that could leave retirees with inadequate retirement income and could jeopardize the financial stability of the country.<sup>164</sup> With great risk came strong regulation, as discussed in Part II.<sup>165</sup> In order to ameliorate both the risk and the regulatory burdens borne under defined benefit plans, employers gradually shifted the risk of funding and administering retirement benefits onto employees by adopting and proliferating self-directed defined contribution plans.<sup>166</sup> In our defined contribution society, we are left with the question: If the purpose of ERISA is protecting workers' retirement benefits, is that purpose best served by shifting risks onto the workers and reducing both oversight and safety nets for retirement savings?

Under a self-directed defined contribution model, three important risks are shifted to employee investors—market performance, information risks, and longevity risks.<sup>167</sup> In shifting these responsibilities to employees, these risks also became largely unregulated.<sup>168</sup> In contrast, under the defined benefit model, employers bore these risks and were the subject of extensive ERISA regulations.<sup>169</sup> The few ERISA protections that remain in place for self-directed defined contribution plans are eliminated<sup>170</sup> once an employee retires or changes

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162. See Gelter, *supra* note 20, at 922 (“The predominant form of private pension was the defined benefit (DB) plan, under which an employee receives a pension of a specified amount upon retirement.”).

163. See *supra* note 52 and accompanying text (describing defined benefit plans).

164. See *supra* note 49.

165. *Supra* Part II.

166. See Gelter, *supra* note 20, at 923 (discussing the change from defined benefit to defined contribution plans).

167. See *infra* Part IV.A–C (describing each risk in detail).

168. MUNNELL & SUNDÉN, *supra* note 6, at 9 (“The defining characteristic of 401(k) plans is that they shift the risks and responsibilities associated with providing retirement income from the employer to the employee. Shifting the risk means that employees both enjoy the gains and suffer the losses of their investment decisions.”); Zelinsky, *supra* note 5, at 458 (“[D]efined contribution arrangements shift the risk of poor (and the rewards of better) investment performance to the employee, because her entitlement under the plan is her account balance, however low (or high) that balance might be.”).

169. See *supra* notes 68–72 and accompanying text (discussing regulatory burdens and risks).

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[U.S.] retirees effectively have fewer regulatory protections than do most workers. This is an unintended consequence of the nation's system of defined-contribution retirement savings. . . . However, almost all retirees eventually roll

jobs and moves the investment into a private account such as an IRA.<sup>171</sup>

Regardless of the reader's normative view of the efficacy of the defined contribution society, it is unquestionably in place and shapes how a majority of Americans invest in the market as well as the financial security of both individuals and our nation. One consequence of the retirement revolution is the shifting of significant risks onto participants, risks that were borne by employers and federally backed safety nets like the PBGC under the pension paradigm. Risk should be a critical component of debates about the role of citizen shareholders in our markets, securities regulations, and corporate governance regimes. This model of retirement savings poses a unique set of risks for investors entering the market—risks that are not lessened under the ERISA regulatory framework. The following Part describes the limitations of the ERISA framework with regard to citizen shareholders.

#### A. *Market Performance Risks*

In a defined contribution society, the individual financial security of many Americans and the general financial security of our country in future decades are inextricably intertwined with the success of capital markets.<sup>172</sup> The most dramatic risk shifted from defined benefit to self-directed defined contribution plans is that participants bear the risks of market performance.

Under the defined benefit paradigm, employers' pension funds were often invested heavily in securities markets, and thus, employers bore the risk of market performance.<sup>173</sup> In other

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their accumulated balances out of ERISA-regulated accounts into Individual Retirement Accounts (IRAs), which are regulated with a much lighter touch. For example, the broker-dealer securities firms that manage most IRAs have no fiduciary duty toward their customers. Thus, the system currently provides the least regulation for precisely the age group with the greatest vulnerability.

Agarwal et al., *supra* note 58, at 53–54.

171. Medill, *supra* note 33, at 343.

In 2004, assets held in IRAs were valued at \$3.48 trillion. By comparison, assets held in all employer-sponsored defined contribution plans (primarily 401(k) plans) were valued at \$2.68 trillion in 2004. These numbers suggest that IRAs, not employer-sponsored plans, will be the most significant source of non-Social Security income for future retirees.

*Id.* (citations omitted).

172. MUNNELL & SUNDÉN, *supra* note 6, at 68 (“[R]etirement income in 401(k) plans depends on the success of the participant's investment choices. Moreover, most participants' financial security in retirement rests on these choices because the 401(k) often represents the bulk of the family's financial assets.”).

173. See KOZAK, *supra* note 4, at 86 (“In all types of defined benefit plans . . . the risk of large investment losses remains with the employer.”).

words, if the market declined it was the pension fund/employer that had to make up the difference, not the retiree. Most employees enrolled in self-directed defined contribution plans depend upon average market returns to build retirement savings over a lifetime.<sup>174</sup> As discussed above, mutual funds are a popular investment vehicle for individual investors fueled, in part, by the rise in self-directed defined contribution plans.<sup>175</sup> Defined contribution plans also offer investment options other than mutual funds, such as bonds, money market accounts, and company stock, but mutual and index funds are the most appealing option because they satisfy portfolio diversification needs.<sup>176</sup> Citizen shareholders bear the risks of their investments (i.e., a negative return) without robust traditional shareholder protections and without the benefit of an employer-provided safety net, or the PBGC,<sup>177</sup> as exists under defined benefit plans.<sup>178</sup>

### B. Information Risks

Related to portfolio performance and market risks are investment information access and asymmetry risks. Information risks include the ability to assess the market and make investment decisions that generate long-term returns as well as demonstrate general financial literacy.<sup>179</sup> In defined benefit models, employers, designated trustees, or paid investment advisors oversee pension

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174. Gelter, *supra* note 20, at 928 (noting that “[p]otential retirees are therefore to a large extent dependent on the development of the stock market, and to a lesser extent, of the bond market,” and the reason for the dominance of equity is that “it is the only type of investment that yields profits that are high enough ‘to make retirement income programs work’” (citation omitted)).

175. *See supra* note 50.

176. *See Beginners’ Guide to Asset Allocation, Diversification, and Rebalancing*, SEC, <http://www.sec.gov/investor/pubs/assetallocation.htm> (last visited Sept. 20, 2013).

Because achieving diversification can be so challenging, some investors may find it easier to diversify within each asset category through the ownership of mutual funds rather than through individual investments from each asset category. A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, and other financial instruments. Mutual funds make it easy for investors to own a small portion of many investments. A total stock market index fund, for example, owns stock in thousands of companies.

*Id.*

177. *See* MUNNELL & SUNDÉN, *supra* note 6, at 47–49; *see also supra* text accompanying notes 84–89 (discussing investment risks and the PBGC).

178. *See* MUNNELL & SUNDÉN, *supra* note 6, at 47 (“One type of financial risk is the possibility that the real rate of return will fall below historic norms during the accumulation phase. That is, if the stock market falls, the sponsor of a defined benefit plan must cover promised benefits. In a 401(k) plan, the participant suffers the loss.”).

179. *See* Medill, *supra* note 33, at 329, 333 (describing investors’ need of “the motivation and knowledge necessary to save and invest”).

fund investment decisions.<sup>180</sup> Under a self-directed defined contribution model, in contrast, the individual employee allocates investments within the options offered by the plan; thus, the information risk passes to the individual.<sup>181</sup> Shifting the information risk to individual participants is problematic because of information asymmetries, general financial illiteracy, current methods of providing investor education, and greater likelihood of bad decisions with insufficient information. The decisions involved in self-directed retirement investments implicate high information costs,<sup>182</sup> and the consequences of poor decisions have the potential to be individually and socially disastrous.

Citing to a 2004 study, Professor Lusardi concluded that “workers continue to be uninformed about the rules and the benefits associated with their [retirement benefits], despite the large shift . . . from [defined benefit] to [defined contribution] plans, which has [given] workers more [retirement savings] responsibility.”<sup>183</sup> In a comprehensive review of the efficacy of investment warnings, Professor Palmiter surveyed existing consumer behavior and knowledge research, concluding that:

These studies paint an unflattering portrait of the typical mutual fund investor. They find that fund investors generally are uninformed and financially unsophisticated. For example, most investors are unaware of the investment objectives, composition, fees and expenses, and risks of their funds. Although investors pay little attention to a fund’s objectives, risk, and costs, they pay great attention to a fund’s historical returns.<sup>184</sup>

The information deficit by self-directed defined contribution participants is not wholly unaddressed by ERISA; employers are

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180. Zelinsky, *supra* note 5, at 458 (discussing employer investment responsibility under defined benefit plans).

181. See KOZAK, *supra* note 4, at 86 (“In all types of defined contribution plans, the risk of large investment losses . . . remains with each individual participant.”).

182. Medill, *supra* note 33, at 333 (“Retirement financial planning involves high information costs in determining and assessing available options, and then using those options to manage various types of financial risks.” (citation omitted)); see also *id.* at 334–35 (discussing high information costs of investment decisions and coping mechanisms for participants such as the endorsement effect, framing effects, and risk/loss aversion).

183. Annamaria Lusardi, *Household Savings Behavior in the United States: The Role of Literacy, Information, and Financial Education Programs*, in POLICYMAKING INSIGHTS FROM BEHAVIORAL ECONOMICS 109, 121 (Christopher L. Foote et al. eds., 2009).

184. Mercer, Palmiter & Taha, *supra* note 147, at 432 (citation omitted).

required to provide participants with account statements.<sup>185</sup> In addition, plan participants receive a Summary Annual Report<sup>186</sup> and notices regarding portfolio diversification, automatic enrollment (if applicable), default investment options (if applicable), and fees.<sup>187</sup> Disclosures, while politically expedient solutions, pose problems in application and effectiveness.<sup>188</sup> Additional disclosures, in conjunction with the countless other forms of notice, are considered “noisy” and “easy for investors to ignore,” often generating compliance costs and sources of litigation but little in way of applicability to the end-user.<sup>189</sup>

The information asymmetry is not just an absence of information; it is also an absence of knowledge about how to process available information.<sup>190</sup> Financial illiteracy of many participants<sup>191</sup> is “particularly acute among specific demographic groups such as women, African-Americans, Hispanics, and those with low levels of education.”<sup>192</sup> There is a significant, positive correlation between financial literacy and retirement planning and performance.<sup>193</sup> Financial illiteracy

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185. 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1)–(2) (2006); Usha Rodrigues & Mike Stegemoller, *Placebo Ethics: A Study in Securities Disclosure Arbitrage*, 96 VA. L. REV. 1, 45 (2010) (discussing how information embedded in disclosures can be muddled and easy to ignore because of other information included in such disclosures).

186. KOZAK, *supra* note 4, at 405.

The SAR must contain specific information: for defined contribution plans: financial statement for employee pension benefit plans; and the number of employees, name and address of each fiduciary, the name of and reason any person received compensation to perform services for the plan, and a reason for the change on any material plan advisor.

*Id.* at 409.

187. *Id.* at 405. Recent forms focus on additional disclosures for participants. See *Fact Sheet: Final Rule to Improve Transparency of Fees and Expenses to Workers in 401(k)-Type Retirement Plans*, U.S. DEPT OF LABOR (Feb. 2012), <http://www.dol.gov/ebsa/newsroom/fsparticipantfeerule.html> [hereinafter *Fact Sheet*]. For a more complete discussion of proposed disclosure reforms, see Part VI.B.2.

188. Rodrigues, *supra* note 112, at 1824.

189. *Id.* at 1853–54.

190. See Gavin Clarkson, *Wall Street Indians: Information Asymmetry and Barriers to Tribal Capital Market Access*, 12 LEWIS & CLARK L. REV. 943, 947 (2008) (“[I]nformation asymmetry exists when a party possesses greater informational awareness pertinent to effective participation in a given situation relative to other participating parties.”).

191. Lusardi, *supra* note 183, at 109 (describing “widespread” financial illiteracy).

192. *Id.* (citation omitted).

193. Medill, *supra* note 33, at 337–38.

Numerous research studies have found that even when controlling for disparities in income levels, there is a strong positive correlation between the level of financial literacy and the amount of personal retirement savings. The causal link between the two centers on the planning process. Researchers hypothesize that greater financial literacy improves retirement savings because

threatens the success of individual retirement savings as well as the social safety net of retirement where our policies strive to facilitate comfortable retirements for an aging population. A criticism of the ERISA disclosure policies and practices is that they are “dishonest.”<sup>194</sup> “A policy based on the providing of information to participants that is not provided, and on the assumption that participants will use this information on their own in ways that they can not, are essentially a fictitious construct.”<sup>195</sup>

The ERISA framework is ill-equipped to address financial literacy deficiencies with few resources dedicated to participant education aimed at compensating for these shifting risks. Under ERISA, employer sponsors are not required to provide financial education or advice to participants.<sup>196</sup> The Department of Labor (DOL) oversees any employer/employee education initiatives implemented.<sup>197</sup> Employers must provide some additional information upon request, such as fee comparisons and charges that may reduce return rates.<sup>198</sup> Despite these limitations,

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it counters psychological biases and improves the cognitive ability of individuals to collect and evaluate information concerning their options. Significantly, researchers have shown that improved financial literacy correlates with higher levels of retirement savings by all workers, not just those with high incomes.

*Id.*; see also Lusardi, *supra* note 183, at 113–20 (discussing the correlation between financial planning behaviors and wealth accumulation).

194. Herbert A. Whitehouse, *The Use of ERISA § 3(38) Investment Managers in Plans Offering Mutual Fund Investment Options to Participants* § 1.07 (Apr. 15, 2011) (unpublished manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1811085](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1811085).

195. *Id.*

196. Medill, *supra* note 33, at 338 (“Employers are not required to provide investment educational materials to 401(k) plan participants, and many employers do not.”); see also 29 C.F.R. § 2550.404c-1(c)(4) (2006) (“A fiduciary has no obligation under part four of Title I of the Act to provide investment advice to a participant or beneficiary under an ERISA section 404(c) plan.”); 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1)–(2) (noting that “there is no obligation to provide investment advice at any time” under section (c)(4)); Participant Directed Individual Account Plans, 57 Fed. Reg. 49,906, 46,922 (Oct. 13, 1992) (codified at 29 C.F.R. pt. 2550).

197. In the 1997 Savings Are Vital to Everyone’s Retirement (SAVER) Act, Congress vested the Department of Labor (DOL) with the responsibility to encourage retirement financial education. 29 U.S.C. §§ 1146–1447 (2000). Congress found that “far too many Americans—particularly the young—are either unaware of, or without the knowledge and resources necessary to take advantage of, the extensive benefits offered by our retirement savings system.” Savings Are Vital to Everyone’s Retirement (SAVER) Act of 1997, Pub. L. No. 105-92, § 2(a)(3), 111 Stat. 2139, 2139. To promote retirement savings through education, the DOL was tasked with creating an ongoing public education program. 29 U.S.C. § 1146; SAVER Act of 1997, Pub. L. No. 105-92, § 2(a)(3), 111 Stat. 2139, 2139.

198. Medill, *supra* note 33, at 345–46.

Employers are not absolutely required to provide participants in their 401(k) plans with a comparative description of the investment management fees and other charges that may reduce the rate of return for each investment option available under the plans. Rather, an employer must provide this information

employer education is a common source of financial information,<sup>199</sup> as is information from friends and families.<sup>200</sup> The platform of employer-provided financial education is criticized as being ineffective or marginally effective (i.e., raising awareness but not changing behaviors) and geared towards those likely to already be engaged in some form of financial planning rather than overcoming fundamental knowledge gaps for participants.<sup>201</sup>

The consequences of these information asymmetries are significant: without proper information participants charged with managing their retirement accounts make poor and too few choices. For example, many participants do not save enough and erode accumulated savings with early withdrawals or loans.<sup>202</sup> Specifically, one in four American households make pre-retirement withdrawals for nonretirement spending

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only if a participant affirmatively requests the information. Furthermore, employers are not required to explain to participants how even a slightly higher investment management fee, compounded over time, can significantly reduce their account balances at retirement.

*Id.*; see also 29 C.F.R. § 2550.404c-1(b)(2)(i)(B)(1) (listing mandatory disclosure information that employers must divulge to plan participants); *id.* §§ 2550.404c-1(b)(2)(i)(B)(2)(i)–(ii) (describing the information the fiduciary must provide the beneficiary).

199. Medill, *supra* note 33, at 338 (“The most likely source of financial education is from an employer who sponsors a 401(k) plan.”).

200. Lusardi, *supra* note 183, at 134 (describing research establishing that default contribution rates in defined contribution plans are too low and lead to insufficient savings as well as a failure to capitalize upon employer matching programs and tax deferral savings); see also *id.* at 127–28 (citing family and friends as a primary source of financial information).

201. See Medill, *supra* note 33, at 338–39 (“When employers do provide such educational materials, the quality is uneven. Recent research also suggests that employer-provided educational materials are geared toward individuals who are natural ‘planners’ and that these materials do not appeal to the approximately 50 percent of the working population that is not planning-oriented.”); see also Lusardi, *supra* note 183, at 132 (“After attending the seminar, several participants stated they intended to change their retirement goals, and many revised their expected level of retirement income. . . . However, it was only a minority of participants who were affected by the seminars. Just 12 percent of seminar attendees reported changes in retirement-age goals and close to 30 percent reported changes in retirement-income goals. Moreover, their intentions did not always translate into actions. When interviewed several months later, many of those who had intended to make changes had not implemented them yet.”).

202. See Lusardi, *supra* note 183, at 134 (discussing low savings rates and low default contribution rates). The hidden problem with self-directed 401(k) plans is the lure to cash out retirement savings as needed or when the participant changes jobs rather than roll it over. MUNNELL & SUNDÉN, *supra* note 6, at 39. Another reason for underfunded defined contribution accounts is the role of fees. *Id.* at 76 (“[A] possible explanation for the lower return in defined contribution plans is investment fees, which typically account for 75–90 percent of total expenses associated with managing 401(k) plans. These fees (which compensate providers of, say, mutual funds for selecting the stocks and undertaking the research that leads to buy and sell decisions) are usually assessed as a percentage of invested assets and are paid by the employee through direct deductions from investment returns.”).

needs.<sup>203</sup> Many participants do not adjust initial investment allocations or default allocations for a plan to account for increased salary, age, or retirement needs.<sup>204</sup> Participants consistently make investment allocations based upon the past performance of funds despite extensive empirical evidence (and SEC disclosures) that past returns are not a guarantee or even a good predictor of future, positive returns.<sup>205</sup> Additionally, if available, participants tend to overinvest in company stock as a part of an employee stock option plan due to familiarity, endorsement, and loyalty biases.<sup>206</sup>

Behavioral economics provides some explanation for these results. In the absence of tools to make informed decisions, participants may rely upon biases and information heuristics to manage their retirement savings, including “procrastination (people delay saving, do not save, or do not save enough), inertia (people stay where they are), and immobilization (whereby conflicts and confusion lead people to behave passively, like a

203. Stephen Miller, *Preretirement 401(k) Breaches on the Rise: Household Budgets and Emergency Funds Can Help Workers Avoid Raids on Their 401(k)s*, SOC’Y FOR HUMAN RES. MGMT. (Jan. 25, 2013), <http://www.shrm.org/hrdisciplines/benefits/Articles/Pages/Preretirement-401k-Breaches.aspx>.

204. MUNNELL & SUNDÉN, *supra* note 6, at 91 (“[Forty-seven] percent of participants made no changes, and another 21 percent made only one change over the nine-year period. In terms of assets, 73 percent made no changes, and another 14 percent made only one change.”); *see also id.* at 90 (documenting that people do not change investment allocations based upon age or investment return); *id.* at 82–83 (describing failures to reallocate investment based upon returns and disrupting intended plan balances, which create an asset blend that is either too conservative or risky).

205. Mercer, Palmiter & Taha, *supra* note 147, at 430–35 (documenting the reliance of individuals on past performance in making investment allocation decisions and the evidence that dispels a relationship between past high returns and future positive performance).

Capon, Fitzsimons, and Rice’s survey of households that invest in mutual funds found that a fund’s ‘investment performance track record’ was the most important factor in investors’ choice of funds. Also, a survey sponsored by the Investment Company Institute—the trade association of the mutual fund industry—found that 69 percent of fund investors reviewed a fund’s ‘historical performance’ before investing.

*Id.* at 433 (footnotes omitted); *see also* Michael Finke & Shaun Pfeiffer, *Performance Gap: The Impact of Broker Advice and Fund Valuation* 2, 3 (2011) (unpublished manuscript), available at [http://www.academyfinancial.org/10Conference/10Proceedings/\(5B\)%20Finke,%20Pfeiffer.pdf](http://www.academyfinancial.org/10Conference/10Proceedings/(5B)%20Finke,%20Pfeiffer.pdf) (describing recent research confirming that priority investors place on past returns rather than other more predictive fund features, such as fees and costs).

206. Congress did not extend the 10% limit on employer stock holdings that exists with defined benefit plans to defined contribution plans. Choi, Laibson & Madrian, *supra* note 119, at 155. As such, employer sponsors have flexibility with regard to how much company stock to offer in plans. Participant choices regarding company stock, however, may be subject to biases such as loyalty (feeling like they should invest in the company), endorsement (inclusive signals endorsement of the safety of the investment), and familiarity (in a world of unknown investments the informed decision to select the one you know). *Id.* at 157–58.



deer in the headlights).<sup>207</sup> Information asymmetries and inadequate tools to manage individual investment portfolios demonstrate the risk shift under self-directed defined contribution plans and may lead to insufficient savings and exposure to great risks.

### C. Longevity Risks

Another factor that influences the success of retirement savings is the longevity risk, which asks how long retirees will live. Increasing life expectancy increases funding obligations.<sup>208</sup> The longevity risk assumed by defined contribution participants is that they live longer than expected and therefore spend their retirement money before they (or their spouse) die.<sup>209</sup>

Depending on the payment option selected, under defined benefit plans retirees are paid a fixed amount until their death or the death of their spouse so that employers, not the individuals, bear the risk of longevity.<sup>210</sup> Defined benefit plans thus offer an annuity-like payment system, which guarantees a constant sum of money over the remaining life of the participant and any designated beneficiaries.<sup>211</sup> The longevity risk is exacerbated in the defined contribution context because retirement benefits are generally available as a lump sum upon reaching the minimum age of retirement.<sup>212</sup> Once the retirement benefit is

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207. Nicholas Barr & Peter Diamond, *Reforming Pensions: Lessons from Economic Theory and Some Policy Directions*, ECONOMIA, Spring 2011, at 1, 9 (2010).

208. Zelinsky, *supra* note 5, at 458–62 (describing three types of pension benefit risks: investment risk, funding risk, and longevity risk); *see also* MUNNELL & SUNDÉN, *supra* note 6, at 47 (discussing longevity risks of defined contribution plans borne by retirees and the need to purchase annuities).

209. *See* Don Ezra, *How Should Retirees Manage Investment and Longevity Risk in a Defined Contribution World?*, ROTMAN INT'L J. PENSION MGMT., Fall 2011, at 3, 62, available at <http://ssrn.com/abstract=1829342> (describing longevity risk of investments).

210. *See* Zelinsky, *supra* note 5, at 458, 462.

211. *See id.* at 462.

The traditional, annuity-paying defined benefit plan provides at least partial protection against longevity risk because such a traditional pension disburses retirement payments periodically (typically monthly) and continues such annuity-type payments until the participant's death—often with payments continuing at a reduced level to the surviving spouse. With such a lifetime annuity it is by definition impossible for the retiree to outlive her pension income, though that income may decline in real value if it is not increased to reflect increments in the cost of living.

*Id.*

212. At retirement, each participant is entitled to receive the balance of his or her account. Borzi, *supra* note 4, at A-15. These lump-sum distributions of defined contribution plans generate significant challenges of managing and investing that money in light of potential stock market volatility, risks of high inflation/low interest rates, life expectancy, and health care costs. Olivia S. Mitchell & Stephen P. Utkus, *Lessons from*

paid out, the money is beyond the purview of ERISA oversight.<sup>213</sup> Not only must the retiree make assumptions about life expectancy and therefore the anticipated amount needed for retirement, but the retiree must then either monitor distributions from the savings or individually purchase an annuity.<sup>214</sup> While there are justifications for purchasing an annuity upon withdrawing assets from a defined contribution plan, it is neither required, nor is it a common practice.<sup>215</sup> Annuities are expensive to purchase individually and involve a loss of control over the invested assets that can be barriers to consumers' purchase.<sup>216</sup> The longevity risks increase, of course, with rising life expectancy and the rising cost of health care.<sup>217</sup> Longevity risks increase the burden on citizen shareholders and pose a threat to retirement financial security.

In our defined contribution society, individuals are tasked with allocating and monitoring portfolios as well as understanding basic market and longevity risks. Shifting these burdens onto individuals pose obstacles for many—

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*Behavioral Finance for Retirement Plan Design*, in PENSION DESIGN AND STRUCTURE 3, 26–30 (2004). Participants age 59½ or older can withdraw from qualified retirement accounts without incurring an early withdrawal penalty tax of 10%. *Retirement Topics—Tax on Early Distributions*, IRS, <http://www.irs.gov/Retirement-Plans/Plan-Participant-Employee/Retirement-Topics---Tax-on-Early-Distributions> (last updated June 17, 2013).

213. Borzi, *supra* note 4, at A-14.

214. See Ezra, *supra* note 209, at 63 (describing an annuity as “the only way to take longevity risk out of the picture”).

215. See Barr & Diamond, *supra* note 207, at 3 (“Fluctuations in the cumulative return on assets during working life affect the individual account holder by affecting the amount available to finance retirement. If the worker buys an annuity, he or she will have faced the risk in the pricing of annuities, reflecting both mortality projections and asset returns from this point forward. Once the annuity is purchased, however, further fluctuations in asset returns and the development of mortality compared to the projections used in pricing the annuity are borne by the insurance company, unless annuity benefits are indexed for asset returns (a variable annuity) or for mortality realizations . . . . Annuitization shifts risks after retirement to insurers, but the retiree still faces the risk of the pricing of annuities at the start of retirement.”); see also MUNNELL & SUNDÉN, *supra* note 6, at 47 (“The only way that a 401(k) participant or a participant in a new hybrid plan can insure against outliving resources is to purchase an annuity, and the price of that annuity will largely depend on the interest rate at which the insurance company can invest its funds. . . . [T]he employer bears this risk.”).

216. See Ezra, *supra* note 209, at 65 (“[P]eople do not buy annuities voluntarily. They cite a feeling that in buying an annuity they have lost control of their assets.”); see also Margaret Collins, *Income for Life? Sure, But What Does it Cost?*, BLOOMBERG BUSINESSWEEK, June 27–July 3, 2011, at 47, 47–48 (describing annuity protections as coming with high cost and many conditions that make comparing and selecting the appropriate annuity difficult for consumers).

217. See generally *Global Financial Stability Report, Chapter 4: The Financial Impact of Longevity Risk*, IMF (Apr. 2012), <http://www.imf.org/external/pubs/ft/gfsr/2012/01/pdf/c4.pdf> (discussing the impact of life expectancy and health care on longevity risks and financial stability of governments, private companies and individuals).

disproportionately affecting women and minority investors.<sup>218</sup> Financial literacy deficits make shouldering these burdens onerous. Additionally, the ERISA framework is not equipped to address this deficit with minimal resources focused on voluntary education programs and ineffective participant disclosures.<sup>219</sup> The gamble involved in the defined contribution society involves potential negative impact on individual and social financial stability.

#### V. DILUTED ERISA FIDUCIARY STANDARDS FOR CITIZEN SHAREHOLDERS

ERISA, which was premised on strong fiduciary duties and oversight of employers and other designated actors in the defined benefit context, relaxed, if not eliminated, many of those protections for self-directed defined contribution participants.<sup>220</sup> As a result, the traditional protections associated with retirement benefits are largely absent for the citizen shareholder in a defined contribution plan.<sup>221</sup>

Sponsors and trustees of self-directed defined contribution plans are subject to fiduciary duties that are diluted in scope and diffused among various actors, reducing accountability mechanisms and liability.<sup>222</sup> For example, in self-directed accounts where participants make investment choices, the “choice” creates a safe harbor presumption for the employer and other fiduciaries shielding them against liability.<sup>223</sup> The safe harbor presumption, not present for defined benefit plans, is a barrier to recovery for investors and illustrates the diluted ERISA protections for citizen shareholders.<sup>224</sup> This Part discusses

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218. Lusardi, *supra* note 183, at 124 (“Financial illiteracy is particularly acute among the elderly, African-Americans, Hispanics, women, and those with low education levels . . .”).

219. See *supra* notes 194–201 and accompanying text (discussing financial education and disclosures).

220. Muir, *supra* note 46, at 393–94 (“[ERISA] incorporates, both explicitly and implicitly, a broad range of fiduciary principles to protect people who participate in and benefit from private sector employee benefit plans.” (citations omitted)).

221. See *supra* notes 30–31 and accompanying text (describing protections for citizen shareholders).

222. Muir, *supra* note 46, at 395 (“Unlike traditional trust law, in which each fiduciary is responsible for all fiduciary obligations owed to the trust, ERISA’s functional definition of ‘fiduciary’ results in many fiduciaries, each with limited responsibilities.”).

223. ERISA § 404(c), 29 U.S.C. § 1104(c) (2006).

224. 29 C.F.R. § 2550.404c-1(d)(2)(i) (2012) (“If a participant or beneficiary of an ERISA section 404(c) plan exercises independent control over assets in his individual account in the manner described in paragraph (c), then no other person who is a fiduciary with respect to such plan shall be liable for any loss, or with respect to any breach of part 4 of title I of the Act, that is the direct and necessary result of that participant’s or beneficiary’s exercise of control.”); see also *DiFelice v. US Airways, Inc.*, 397 F. Supp. 2d

the fiduciary standards imposed by ERISA, the classification of fiduciaries, and exceptions to liability, and it examines certain fee and stock drop cases. This Part also discusses specific defined contribution causes of action that seek liability despite the “safe harbor” because certain structural plan decisions, such as investment options, fees, and plan disclosures, greatly impact defined contribution plan outcomes for individual participants and thus warrant accountability to participants.

#### A. *ERISA Fiduciary Duties*

ERISA imposes duties on fiduciaries who govern both defined benefit and defined contribution plans, although, as discussed below, those duties are diluted with regard to self-directed defined contribution plans.<sup>225</sup> For a plaintiff to successfully raise a fiduciary duty claim, the action in question must be taken by a fiduciary, and it must have violated one of the enumerated fiduciary duties under ERISA.<sup>226</sup> If an actor manages plan assets, renders investment advice, or is vested with discretionary authority over the plan and is therefore a fiduciary, such an actor must act (1) “solely in the interest of the plan’s participants and beneficiaries,” (2) for the exclusive purpose of “defraying reasonable expenses of administering the plan,” (3) “with the care, skill, prudence, and diligence of a prudent [person] in similar [situations],” (4) consistent with diversification principles, (5) in accordance with plan documents, and (6) without conflicts of interest or self-dealing.<sup>227</sup>

ERISA fiduciaries are held to standards described as “the highest known to the law.”<sup>228</sup> Fiduciaries under ERISA have, in name at least, strong,<sup>229</sup> “twin” fiduciary duties of loyalty and

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758, 775 (E.D. Va. 2005) (holding that the fiduciary was shielded from liability “even when the fiduciary arguably may have breached its duties”).

225. See *infra* Part V (discussing the dilution of fiduciary duties in defined contribution plans).

226. ERISA § 409, 29 U.S.C. § 1109.

227. ERISA § 404(a), 29 U.S.C. § 1104(a); KOZAK, *supra* note 4, at 349–50, 355–57; see also Borzi, *supra* note 4, at A-24; Maher & Stris, *supra* note 88, at 458 (“In virtually all defined contribution pension plans, promisees rely on plan fiduciaries to perform functions that are too difficult or costly for promisees to perform on their own. While some fiduciary obligations, such as the restrictions on ‘prohibited transactions,’ have been expressed in sets of fairly clear rules, the core aspects of fiduciary duties under ERISA are expressed and applied as standards—such as the duty to act ‘solely in the interest of beneficiaries’ and the duty to prudently administer the plan.” (footnotes omitted)).

228. *Dudenhoefer v. Fifth Third Bancorp*, 692 F.3d 410, 417 (6th Cir. 2012) (internal quotation marks omitted) (quoting *Pfeil v. State St. Bank & Trust*, 671 F.3d 585, 591 (6th Cir. 2012)).

229. “Congress intended that private individuals would play an important role in enforcing ERISA’s fiduciary duties—duties which have been described as ‘the highest

prudence.<sup>230</sup> The loyalty obligation, established under section 404(a), requires that fiduciaries act “solely in the interest of [plan] participants and beneficiaries . . . for the exclusive purpose of . . . providing benefits to participants and their beneficiaries.”<sup>231</sup> Fiduciaries must also act to defray the “reasonable expenses of administering the plan.”<sup>232</sup> Fiduciaries may not, without violating the fiduciary duty of loyalty, act in favor of a personal benefit or to the benefit of a third party.<sup>233</sup> “[M]ost courts have treated the ‘solely in the interest’ and ‘exclusive purpose’ standards interchangeably as codifications of the trust law duty of undivided loyalty.”<sup>234</sup>

Fiduciaries observe the second pillar, the duty of prudence, by executing plan functions “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”<sup>235</sup> The prudence obligation is an “objective” standard and judicial inquiries focus on the process undertaken by the fiduciary, not necessarily the end result.<sup>236</sup> A fiduciary must “(1) . . . employ proper methods to investigate, evaluate and structure the investment; (2) . . . act in a manner as would others who have a capacity and familiarity with such matters; and (3) . . . exercise independent judgment when making investment decisions.”<sup>237</sup> DOL regulations further clarify the prudence

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known to the law.” *Braden v. Wal-Mart Stores, Inc.*, 588 F.3d 585, 598 (8th Cir. 2009) (citing *Donovan v. Bierwirth*, 680 F.2d 263, 272 n. 8 (2d Cir. 1982)).

230. *Id.* at 595 (citing 29 U.S.C. § 1104(a)(1)).

231. ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1).

232. ERISA § 404(a)(1)(A)(ii), 29 U.S.C. § 1104(a)(1)(A)(ii).

233. Robert N. Eccles et al., *Fiduciary Litigation Under ERISA* 21–22 (Dec. 1, 2010) (unpublished manuscript), available at <http://www.asppa.org/DocumentVault/Docs/Conferences/Los%20Angeles%20Benefits%20Conference/2011/ws9.aspx>; see also *Chao v. Malkani*, 452 F.3d 290, 291, 298–99 (4th Cir. 2006) (holding that fiduciaries breached their duties of loyalty by raiding plan assets); *Pension Benefit Guar. Corp. v. Solmsen*, 671 F. Supp. 938, 945–46 (E.D.N.Y. 1987) (using plan assets for corporate purposes violates a fiduciary’s duty of loyalty).

234. Eccles et al., *supra* note 233, at 21; see also *Eaves v. Penn*, 587 F.2d 453, 457 (10th Cir. 1978) (treating the standards interchangeably when considering whether the fiduciary’s responsibilities under ERISA section 404(a)(1) were met).

235. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

236. “The statute’s ‘prudent person standard is an objective standard . . . that focuses on the fiduciary’s conduct preceding the challenged decision.’ In evaluating whether a fiduciary has acted prudently, we therefore focus on the process by which it makes its decisions rather than the results of those decisions.” *Braden v. Wal-Mart Stores, Inc.*, 588 F.3d 585, 595 (8th Cir. 2009) (citations omitted).

237. *In re State St. Bank & Trust Fixed Income Funds Litig.*, 842 F. Supp. 2d 614, 645 (S.D.N.Y. 2012) (quoting *United States v. Mason Tenders Dist. Council of*

standard by requiring fiduciaries to give “appropriate consideration” to facts relevant to the investment and the plan’s portfolio.<sup>238</sup> With defined contribution plans, the prudence standard applies primarily to the selection of investments and administration of the plan, rather than the performance of individually invested assets.<sup>239</sup> In addition to these twin duties, fiduciaries responsible for governing any qualified plan have a duty to diversify assets and follow plan documents.<sup>240</sup> The diversification obligation imposes duties on fiduciaries to “minimize the risk of large losses”<sup>241</sup> consistent with a modern portfolio investment approach of asset diversification.<sup>242</sup> The duty to diversify under ERISA “prohibits a fiduciary from investing disproportionately in a particular investment or enterprise.”<sup>243</sup> Rather than establishing a percentage, diversification requirements are based upon the consideration of factors such as purpose of the plan, amount of the plan assets, financial conditions, investment type, distribution among industries, and maturity dates.<sup>244</sup> Diversity is evaluated within each investment option or, when there are several managers/investment types within a single plan, the

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Greater N.Y., 90 F. Supp. 882, 886 (S.D.N.Y. 1995)).

238. 29 C.F.R. § 2250.404a-1(b)(1) (2012). Appropriate consideration includes:

- (i) a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunities for gain (or other return) associated with the investment or investment course of action, and
- (ii) Consideration of the following facts as they relate to such [portion of the portfolio]:
  - (A) The composition of the portfolio with regard to diversification;
  - (B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and
  - (C) The projected return of the portfolio relative to the funding objectives of the plan.

*Id.* § 2550.404a-1(b)(2).

239. Emily Adams, *Protecting America’s Financial Future: Why Courts Should Enforce ERISA’s Duties of Prudence and Disclosure*, 26 A.B.A. J. LAB. & EMP. L. 345, 349–50 (2011).

240. ERISA § 404(a)(1)(A)–(D), 29 U.S.C. § 1104(a)(1)(A)–(D).

241. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C).

242. *Id.*; see also KOZAK, *supra* note 4, at 356 (“Courts have recently held that . . . investment diversification should adopt modern portfolio theory.”). For a discussion of modern portfolio theory, see MUNNELL & SUNDÉN, *supra* note 6, at 79, which describes the portfolios as efficient because “it is not possible to achieve a higher return without taking on additional risk.”

243. *In re Unisys Sav. Plan Litig.*, 74 F.3d 420, 438 (3d Cir. 1996).

244. H.R. Conf. Rep. No. 1280, 93d Cong., 2d Sess. (1974), reprinted in 1974 U.S.C.C.A.N. 5038, 5084–85; see also *In re Unisys*, 74 F.3d at 438 (listing factors to be considered when measuring ERISA’s duty to diversify).

portion of the plan accountable to each fiduciary.<sup>245</sup> For example, in a plan offering mutual fund investments, money market savings, and bonds, diversification for each of the three types of investments would be evaluated individually rather than examining the composite diversification among the three investment types.<sup>246</sup> If a plaintiff establishes a failure to diversify, the burden then shifts to the defendant to demonstrate that the lack of diversification was prudent.<sup>247</sup> The diversification duty is modified when company stock, in the form of an ESOP, is offered as an investment option within a plan.<sup>248</sup>

### B. ERISA Fiduciary Status

Who owes the fiduciary duties described above? ERISA imposes fiduciary duties on plan fiduciaries like the sponsoring employer and any entity named in the plan documents, appointed by the board, or performing “fiduciary functions” for the plan.<sup>249</sup> Determining fiduciary status under ERISA is a factually and legally complex endeavor, often a primary focus of litigation.<sup>250</sup> The third category of “functional fiduciary” is frequently a crucial component of litigation regarding defined contribution plans in which a host of actors beyond the employer and designated trustees make structural plan decisions regarding investment options, plan administration, plan fees, and plan disclosures.<sup>251</sup> For example, within a self-directed

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245. *In re State St. Bank & Trust Fixed Income Funds Litig.*, 842 F. Supp. 2d 614, 650–51 (S.D.N.Y. 2012) (quoting *In re Unisys*, 74 F.3d at 438–40). Diversification is measured with respect to the plan assets in question, not with respect to all of the investments within a plan. See *GIW Indus., Inc. v. Trevor, Steward, Burton & Jacobsen, Inc.*, 895 F.2d 729, 733 (11th Cir. 1990) (rejecting evaluating diversification of the entire plan rather than the plan assets in question); H.R. Conf. Rep. No. 1280 (indicating that investments within different types of vehicles such as equities or bonds must be diversified).

246. *In re State St. Bank*, 842 F. Supp. 2d at 650–51.

247. H.R. Conf. Rep. No. 1280; see also *In re Unisys*, 74 F.3d at 438.

248. Publicly traded companies may offer company stock as an investment option in their 401(k) plans. ERISA § 404(a)(1)(B)–(C), 29 U.S.C. § 1104(a)(1)(B)–(C) (2006); 29 CFR § 2550.404c-1(d)(2)(ii)(E)(4) (2012). Company stock is often offered as a part of an employee stock ownership plan, also known as an ESOP. “[E]mployer stock regulations for 401(k) plans with an ESOP differ from those for plans without one.” Choi, Laibson & Madrian, *supra* note 119, at 155. For a general discussion of ESOPs and a summary of the unique standards of review associated with them, see *Lanfear v. Home Depot, Inc.*, 679 F.3d 1267, 1279 (11th Cir. 2012) (describing ESOP standards of review and compliance duties); see also *Jara*, *supra* note 119, at 547–48 (discussing ESOP plans).

249. 29 U.S.C. § 1002(21)(A); *In re Luna*, 406 F.3d 1192, 1201 (10th Cir. 2005).

250. “The determination of an individual’s fiduciary status is an inherently factual inquiry and will require analysis of the specific facts and circumstances of each case.” KOZAK, *supra* note 4, at 350.

251. See, e.g., *Pegram v. Herdrich*, 530 U.S. 211, 231 (2000) (holding that eligibility

defined contribution plan, in addition to the sponsoring employer, its corporate board, and named fiduciaries or trustee in the plan documents, there are often also investment advisors who help populate the plans, investment brokers who administer the buying and selling of plan assets, administrative/record-keeping third parties, and then the intermediary managers who manage participant contributions invested in participating mutual or index funds.<sup>252</sup> Each of these actors impacts individual performance of retirement accounts, but most are not ERISA fiduciaries.<sup>253</sup> The result is both weakened fiduciary duties and a narrow scope of who is a fiduciary in the context of self-directed defined contribution plans, despite a wide range of actors who influence the structure and administration of the plan.

Determining ERISA fiduciary status requires both a statutory and a functional analysis. The documentation for each plan must identify a named fiduciary, who has general fiduciary responsibility for the entire plan and therefore is a statutory fiduciary.<sup>254</sup> Additionally, to the extent that any person or entity (i) exercises discretionary authority or control over the management or payment of assets, (ii) gives investment advice regarding plan assets for any compensation,<sup>255</sup> or (iii) has any discretionary authority over plan administration, he or she is acting as a “functional” fiduciary of the plan.<sup>256</sup> In applying this standard, DOL regulations establish that certain positions, such as a plan trustee or plan administrator, are “fiduciary” by the nature of the role performed.<sup>257</sup> All other determinations depend upon the nature of the function performed, not just the status or title of the person or entity acting.<sup>258</sup>

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decisions by the employer are not fiduciary decisions under ERISA).

252. *Id.*

253. *Id.*

254. 29 U.S.C. § 1102(a)(1).

255. Definition of the Term “Fiduciary”, 75 Fed. Reg. 65,263-02 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. pt. 2510) *available at* <http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=24328&AgencyId=8&DocumentType=1>.

256. *See* Muir, *supra* note 46, at 395 (explaining that an individual becomes an ERISA fiduciary when they exercise discretion over the assets, management, or administration of the plan or they provide investment advice for compensation).

257. 29 C.F.R. § 2509.75-8 (2012).

258. *Mertens v. Hewitt Assocs.*, 508 U.S. 248, 262 (1993); *Beddall v. State St. Bank & Trust*, 137 F.3d 12, 18 (1st Cir. 1998) (“The statute also extends fiduciary liability to functional fiduciaries.”); *Acosta v. Pac. Enters.*, 950 F.2d 611, 618 (9th Cir. 1991) (“A person’s actions, not the official designation of his role, determine whether he enjoys fiduciary status.”); Deborah S. Davidson & Simon J. Torres, *Fiduciary Responsibility Under ERISA*, in 1 ABA 25TH ANNUAL NATIONAL INSTITUTE ON ERISA BASICS, at B-19 (2011).



The control standard is a high threshold to meet, and mere participation in a plan will not satisfy it for purposes of attaching fiduciary standards.<sup>259</sup> For example, a broker administering a self-directed defined contribution plan would not incur liability for those functions unless the broker had control over the plan assets or provided advice to plan participants.<sup>260</sup> In *Hecker v. Deere Co.*, the plaintiffs alleged that Fidelity Trust, the broker for the defined contribution plan, “played a role in” selecting the list of funds included in the plan from which participants had to invest.<sup>261</sup> The Seventh Circuit Court of Appeals affirmed the dismissal of the plaintiffs’ complaint, distinguishing control that would give rise to liability from merely “play[ing] a role” in plan fund selections.<sup>262</sup> The defined contribution plan in *Hecker* contained twenty “primary” mutual funds in the plan as well as a brokerage window option that granted investors access to a broader range of securities—2,500 investments traded on public indices.<sup>263</sup> By assisting in selecting the twenty “primary” funds, the broker did not exercise control sufficient to establish fiduciary status and attach corresponding fiduciary duties.<sup>264</sup>

Additionally, ERISA fiduciary standards only apply to the extent that an actor is engaged in a fiduciary function.<sup>265</sup> For example, courts applying ERISA case law recognize that employers and other actors can wear “two hats” and only be exposed to liability when performing a plan fiduciary function.<sup>266</sup> This is particularly applicable to employers who

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259. *Beddall*, 137 F.3d at 17–18 (affirming the dismissal of plaintiff’s complaint because the Bank retained no discretionary authority over the plan’s real estate investments).

260. *See* *Kerns v. Benefit Trust Life Ins. Co.*, 992 F.2d 214, 217–18 (8th Cir. 1993) (“Persons who provide professional services to plan administrators ‘are not ERISA fiduciaries unless they transcend the normal role’ and exercise discretionary authority.” (quoting *Martin v. Feilen*, 965 F.2d 660, 669 (8th Cir. 1992))).

261. “Each plan participant decided for herself where to put her 401(k) dollars; the only limitation was that the investment vehicle had to be one offered by the Plan. Each fund included within the Plans charged a fee, calculated as a percentage of assets the investor placed with it.” *Hecker v. Deere & Co.*, 556 F.3d 575, 578, 584 (7th Cir. 2009).

262. “There is an important difference between an assertion that a firm exercised ‘final authority’ over the choice of funds, on the one hand, and an assertion that a firm simply ‘played a role’ in the process, on the other hand.” *Id.* at 584.

263. *Id.* at 581.

264. *Id.* at 583–84.

265. 29 U.S.C. § 1002(21)(A) (2006); *see also* *Beddall v. State St. Bank & Trust*, 137 F.3d 12, 18 (1st Cir. 1998) (“[F]iduciary status is not an all or nothing proposition; the statutory language indicates that a person is a plan fiduciary only ‘to the extent’ that he possesses or exercises the requisite discretion or control.”).

266. The “two hats” doctrine provides that when an individual is acting in a corporate capacity on behalf of the company, ERISA’s fiduciary duties are not implicated.

engage in many activities that are outside of the scope of the ERISA framework.<sup>267</sup> Additionally, ERISA contains specific disclaimers of fiduciary responsibility with regard to what are called “settlor” functions of a plan.<sup>268</sup> Settlor functions include “establishing, funding, amending, and terminating” the benefit plan.<sup>269</sup> In this regard, the fiduciary standard only attaches to a fiduciary actor when it is engaged in a fiduciary function such as managing plan assets, giving investment advice, or exercising discretion over the plan.<sup>270</sup> Although a fiduciary can wear two hats, it must wear only one at a time and it always wears the “fiduciary hat when making fiduciary decisions.”<sup>271</sup>

ERISA establishes a complex and seemingly comprehensive framework of protections for participants with both named and functional fiduciaries and duties that range from broad concepts such as loyalty and prudence to specific duties regarding disclosures, fees, and diversification obligations.<sup>272</sup> This

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*Pegram v. Herdrich*, 530 U.S. 211, 225–26 (2000) (noting that the employer can switch between wearing its “fiduciary” and “employer” hats); *see also* *Holdeman v. Devine*, 474 F.3d 770, 778 (10th Cir. 2007) (recognizing that an employer can wear two hats as a fiduciary and a non-fiduciary employer).

267. Some ERISA-related actions are not fiduciary functions. Those actions, called settlor functions, include “establishing, designing, amending or terminating an ERISA plan” as those decisions relate to the voluntary nature of pension benefits rather than administering them once promised. *See, e.g.*, *Davidson & Torres*, *supra* note 258, at B-21. “The critical distinction for purposes of fiduciary obligation, and ultimately for liability, lies in the line drawn between implementation actions, such as the misrepresentations made by Varity, and settlor actions, such as the participant transfers made by B.F. Goodrich or the benefit amendments made by Hughes Aircraft.” *Muir*, *supra* note 46, at 431.

268. *See* C.F.R. § 2509.75-8, D-2 (2012) (asserting that a person is a fiduciary only if they perform one or more of the functions described in section 3(21)(A) of ERISA with respect to an employee benefit plan). Common ministerial functions include applying eligibility rules, calculating services, preparing employee communications, maintaining employee service records, preparing reports required by the federal government such as form 5550, calculating benefits, orienting new participants, collecting contributions, preparing participant benefit reports, processing claims, and making third-party recommendations regarding plan administration. *Davidson & Torres*, *supra* note 258, at B-34 to B-35.

269. *Adams v. Lockheed Martin Energy Sys.*, 199 F. App’x 405, 407 (6th Cir. 2006) (citing *Hunter v. Caliber Sys., Inc.*, 220 F.3d 702, 718 (6th Cir. 2000)); *see also* *Ames v. Am. Nat’l Can Co.*, 170 F.3d 751, 757 (7th Cir. 1999) (“[W]hen company representatives . . . are not acting in their capacity as a plan fiduciary . . . they do not bear the legal obligations that go along with fiduciary status.”).

270. “[D]espite whatever harm counterclaim defendants may have done to ULLICO, they cannot, as a matter of law, be liable under ERISA’s fiduciary provisions for decisions they made as corporate officers.” *In re Ullico Inc. Litig.*, 605 F. Supp. 2d 210, 220 (D.D.C. 2009). When an employer acts in its corporate capacity, not as a fiduciary, it is performing what is called settlor functions. *See, e.g.*, *Beck v. PACE Int’l Union*, 551 U.S. 96, 101 (2007) (“It is well established . . . that an employer’s decision *whether* to terminate an ERISA plan is a settlor function immune from ERISA’s fiduciary obligations.”).

271. *Pegram v. Herdrich*, 530 U.S. 211, 225 (2000).

272. 29 U.S.C. § 1104(a) (2006).

framework is eroded in the context of self-directed defined contribution plans, and the protections offered to citizen shareholders are substantially weakened.

### C. *Fiduciary Duty Liability and Exceptions*

ERISA section 409 establishes personal liability for any fiduciary breaching “any responsibilities, obligations, or duties imposed upon fiduciaries by [ERISA].”<sup>273</sup> Section 502(a) of ERISA creates a private right of action for plan losses and enumerates the civil actions that investors may bring against fiduciaries for a breach of fiduciary duty.<sup>274</sup> In *LaRue v. DeWolff, Boberg & Associates*, the U.S. Supreme Court affirmed that defined contribution participants have a cause of action against plan fiduciaries “whose alleged misconduct impaired the value of plan assets in the participant’s individual account.”<sup>275</sup> Importantly, *LaRue* established that participants could seek recovery for losses suffered to their individual accounts that were a part of defined contribution plan assets, distinguishing it from precedent that prohibited individual relief, such as consequential damages for delayed payment of benefits.<sup>276</sup>

273. *Id.* § 1109(a).

Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary . . . .

*Id.*

274. *Id.* § 1132. Section 502 also vests the Secretary of Labor as well as plan participants and beneficiaries with the right to bring actions on behalf of the plan for obligations defined in section 409(a). ERISA and securities cases may overlap. Securities fraud (or any derivative claim) cases are typically combined in a consolidated proceeding of multi-district litigation (MDL) before one judge. Clovis Trevino Bravo, *ERISA Misrepresentation and Nondisclosure Claims: Securities Litigation Under the Guise of ERISA?*, 26 HOFSTRA LAB. & EMP. L.J. 497, 527 (2009). Under the Private Securities Litigation Reform Act (PSLRA), a mandatory stay of discovery is imposed pending a ruling on a motion to dismiss. 15 U.S.C. § 78u-4(b)(3)(B) (2006). Because these cases are coordinated with ERISA-based claims where there is no such stay, an exception is made for ERISA-unique discovery. *See, e.g.,* Robert Rachal et al., *ERISA Fiduciary Duties Regarding 401(k) & ESOP Investments in Employer Stock*, in 2 ABA 25TH ANNUAL NATIONAL INSTITUTE ON ERISA BASICS, at M-14 (2011) (discussing PSLRA stays in conjunction with ERISA-based discovery). Coordinating the procedure of such combined cases raises complex issues beyond the scope of this Article. For a thorough discussion of such issues, see Bravo, *supra*, at 527 (describing the procedural and substantive requirements of lawsuits actionable under ERISA and securities law).

275. *LaRue v. DeWolff, Boberg & Assocs.*, 552 U.S. 248, 250 (2008).

276. *Id.* at 256; *Mass. Mut. Life Ins. Co. v. Russell*, 473 U.S. 134, 140 (1985).

1. *Exceptions: Safe Harbors and Discretionary Deference.* Because of clarification by *LaRue* that ERISA private rights of action extend to defined contribution participants, ERISA appears to provide rigorous protections for *all* investors.<sup>277</sup> Two exemptions, however, substantially erode those protections. The first is the safe harbor for self-directed accounts briefly discussed above.<sup>278</sup> The second is judicial deference to discretion in decision-making.<sup>279</sup>

Self-directed accounts, like those in a 401(k), eliminate the need for an employer or other designated third-party to perform many benefit activities that would be considered fiduciary functions under a defined benefit plan, such as investment allocation, funding, and future payments, because those functions are shifted to the citizen shareholders to perform.<sup>280</sup> As a result, section 404(c) of ERISA establishes for fiduciaries an affirmative defense against plan losses if participants exercised control over their accounts in making investment allocations.<sup>281</sup> This affirmative defense, referred to as the safe harbor,<sup>282</sup> shields a fiduciary from liability “even when the fiduciary arguably may have breached its duties.”<sup>283</sup> The limited scope of fiduciary liability for self-directed accounts contributed to the rise of the defined contribution society and also highlights a limitation of ERISA in protecting individual retirement benefits.<sup>284</sup>

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277. *LaRue*, 552 U.S. at 256.

278. See *supra* notes 223–24 and accompanying text.

279. Discretion, a factor crucial in determining fiduciary status, is also a key factor in determining deference, and therefore a significant limitation to finding liability for violated fiduciary standards. Muir, *supra* note 46, at 410.

280.

For defined contribution plans that do not offer the option of investment self-direction, the promisor’s fiduciary role is obvious and enormous: the fiduciary is actively deciding how to invest assets beneficially owned by the plan participant. But even for plans that do offer self-directed accounts (and with respect to promisees who exercise that option), residual fiduciary duties remain.

Maher & Stris, *supra* note 88, at 458 n.124.

281. 29 U.S.C. § 1104(c) (2006).

282.

If a participant or beneficiary of an ERISA section 404(c) plan exercises independent control over assets in his individual account in the manner described in paragraph (c), then no other person who is a fiduciary with respect to such plan shall be liable for any loss, or with respect to any breach of part 4 of title I of the Act, that is the direct and necessary result of that participant’s or beneficiary’s exercise of control.

29 C.F.R. § 2550.404c-1(d)(2)(i) (2012).

283. *DiFelice v. US Airways, Inc.*, 397 F. Supp. 2d 758, 775 (E.D. Va. 2005).

284. See 29 U.S.C. § 1104(c) (limiting fiduciary liability when a participant exercises independent control of individual account assets); see also *Hecker v. Deere & Co.*, 556 F.3d 575, 581 (3d Cir. 2009) (“[T]o the extent participants incurred excessive expenses, those

To qualify for the affirmative defense provided in section 404(c), fiduciaries must establish three elements: (1) the plan at issue offers an individual account over which the participant exercised control, (2) participants must have actually exercised control as authorized under the plan, and (3) the loss or the breach must be the “result of a participant’s exercise of control.”<sup>285</sup> The first two elements—available control and exercised control—are fairly straightforward tests established by ERISA and supporting DOL regulations.<sup>286</sup> In addition to establishing participant control, fiduciaries must establish that the plan included “a sufficient range of options so that the participants have control over the risk of loss.”<sup>287</sup> A sufficient range of options, which means a choice of at least three investment options, is necessary because it facilitates participants’ control over return and risk potential and creates an ability to diversify holdings.<sup>288</sup>

Participants in self-directed defined contribution plans make final investment allocation decisions, which give rise to the safe harbor protections, but there are a myriad of decisions made by employers, trustees, named fiduciaries, investment advisors, brokers, and employer pension committees to select and monitor investment options available in a plan, the fees charged, and the information disseminated to participants.<sup>289</sup> “In virtually all defined contribution pension plans, promisees rely on plan fiduciaries to perform functions that are too difficult or costly for promisees to perform on their own.”<sup>290</sup> I

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losses were the result of participants exercising control over their investments within the meaning of the safe harbor provision.”).

285. *DiFelice*, 397 F. Supp. 2d at 775–76.

286. Individual accounts under ERISA are defined in ERISA section 3(34). 29 U.S.C. § 1002(34). DOL regulations establish a test for determining control if the participant is allowed to:

- (1) Choose from a broad range of investment alternatives . . . each of which has materially different risk and return characteristics;
- (2) give investment instructions with a frequency appropriate in light of the volatility of the investment alternatives . . . ;
- (3) diversify investments within and among investment alternatives; and
- (4) obtain sufficient information to make informed investment decisions with respect to investment alternatives available under the plan.

Final Regulation Regarding Participant Directed Individual Account Plans (ERISA Section 404(c) Plans), 29 C.F.R. § 2550.404c-1 (1992).

287. *Hecker*, 556 F.3d at 589.

288. 29 C.F.R. § 2550.404c-1(b)(3)(i)(A)–(C) (2012) (defining a “broad range of investment alternatives”).

289. 29 U.S.C. § 1104(c)(1)(A); *see also In re Lehman Bros. Sec. & ERISA Litig.*, 683 F. Supp. 2d 294, 298–99 (S.D.N.Y. 2010) (stating that corporate directors who had not been named fiduciaries by the plan did not act as fiduciaries when making administrative plan decision such as appointing the plan committee).

290. *Maher & Stris*, *supra* note 88, at 458.

refer to these preparticipant investment decisions as structural plan decisions. The safe harbor is an affirmative defense to many, but not all, liabilities regarding these structural plan decisions.<sup>291</sup>

Many structural plan decisions require discretionary decision-making. Courts give fiduciaries' discretionary decision-making deference and only find fault if such actions are arbitrary and capricious—a high standard.<sup>292</sup> “Where [an] ERISA plan administrator has ‘discretion,’ i.e., applies his own judgment in making plan decisions, court[s] review[] benefits decisions under arbitrary and capricious standard, which is substantively the same as abuse of discretion standard.”<sup>293</sup> A fiduciary's actions will be overturned only if they were taken in bad faith, lacked “factual foundation,” or were not supported by substantial evidence.<sup>294</sup> The high standard of review is intended to limit excessive judicial intervention so that courts may not substitute their own interpretations of plan provisions for a rational interpretation offered by the plan's fiduciaries.<sup>295</sup>

The safe harbor and discretionary deference create incentives for employer sponsors to (1) provide or convert existing pension benefits into a self-directed defined contribution model where employees perform functions that would otherwise give rise to fiduciary liability; and (2) grant “discretionary authority” to named fiduciaries or delegated/designated parties in the plan document which ensures deferential review.<sup>296</sup> Additionally, because

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291. *Id.* at 458 n.124.

292.

As explained above, one of the determinative factors of ERISA fiduciary status is the presence of discretion in decisionmaking [sic]. Ironically, although the presence of discretion may mean that a plan actor is a fiduciary, that same discretion often protects a fiduciary's decisions from serious scrutiny. The relevant jurisprudence has established that, when a plan document reserves discretion to a fiduciary decision maker, the fiduciary's decisions will be reversed only if they are found to be arbitrary and capricious. Even the decisions of a self-interested fiduciary frequently receive some level of deference.

Muir, *supra* note 46, at 410.

293. Laura Dietz et al., *Plan Administration: Standards of Care for Fiduciaries: Arbitrary and Capricious Standard of Review*, 60A AM. JUR. 2D PENSIONS § 439 (2012) (citing Employee Retirement Income Security Act of 1974, § 502(a)(1)(B), 29 U.S.C. § 1132(a)(1)(B)); *see also* Lipsey v. Union Underwear Pension Plan, 146 F. App'x 326, 330 (11th Cir. 2005) (holding that the employer's determination of plan eligibility was not arbitrary and capricious).

294. Dietz et al., *supra* note 293, § 439.

295. Cook v. Pension Plan for Salaried Emps. of Cyclops Corp., 801 F.2d 865, 869–71 (6th Cir. 1986); Offutt v. Prudential Ins. Co. of Am., 735 F.2d 948, 950 (5th Cir. 1984).

296.

Nonetheless, in a regrettable and unnecessary detour, the Court declared that deferential review would be required where the plan ‘gives the administrator or

fiduciaries are often tasked with determining the scope of the plans' obligations and needs, once such a decision is made, it is then protected from rigorous judicial review, which in turn creates an incentive for drafting vague and ambiguous plan documents to facilitate as much deferential discretion as possible.<sup>297</sup> The combined effect of the safe harbor resulting from self-directed accounts and the judicial deference afforded to discretionary decisions significantly erodes ERISA protections for citizen shareholders.

2. *Defined Contribution Liability in Practice.* Participants in self-directed defined contribution plans bring several types of fiduciary duty cases such as nondisclosure of required plan documents, misrepresentation of material facts or plan changes, excessive fees, conflicts of interest, failure of diversification, and stock drop cases.<sup>298</sup> These claims, however, are rarely successful because of the safe harbor and deferential review procedural barriers discussed above.<sup>299</sup> The result is harsh and is crucial in understanding the limited oversight afforded defined contribution plans. This observation is not a critique of the absence of employer liability per se, but instead seeks to highlight the liability discrepancy between defined benefit and defined contribution plans and the resulting decreased oversight.

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fiduciary discretionary authority to determine eligibility for benefits or to construe the terms of the plan.' The only limit the *Firestone* Court announced on deferential review was that a reviewing court must consider a fiduciary's actual conflict of interest as "a 'facto[r]' in determining whether there is an abuse of discretion." In other words: plans could simply write discretionary authority—and thus deferential review—into the plan document, *and even in the presence of a conflict of interest*, courts must use an abuse-of-discretion review, modified in some unspecified way by the presence of the conflict.

Maher & Stris, *supra* note 88, at 471–72 (footnotes omitted) (quoting *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 115 (1989)).

297.

[T]he fiduciary has the right to determine the existence and scope of the plan's obligations to participants and beneficiaries. Once made, the fiduciary's determination will be reviewed by the courts only for abuse of discretion. The incentives are such that this combination of power to interpret and protection from serious scrutiny might be expected to encourage the drafting of ambiguous plan documents and the avoidance of specificity in benefit obligations.

Muir, *supra* note 46, at 413.

298. See, e.g., *Kirschbaum v. Reliant Energy, Inc.*, 526 F.3d 243, 247 (5th Cir. 2008) (involving a claim relating to a company having invested nearly all of the plan's funds in itself, and finding the company failed to act prudently following a drop in the stock price causing the plan's assets to decrease); Adams, *supra* note 239, at 351–53 (discussing claims brought due to nondisclosure of plan documents, misrepresentation of material facts or plan changes, and excessive fees and revenue sharing).

299. See Charles C. Jackson et al., *Who May Sue You and Why: How to Reduce Your ERISA Risks, and the Role of Fiduciary Liability Insurance*, CHUBB 12–14 (June 2010), <http://www.chubb.com/businesses/csi/chubb12107.pdf>; *supra* notes 278–79 and accompanying text.

Defined benefit participants have a wider safety net of protections and accountability mechanisms, including fiduciary liability.

Disputes over defined contribution plan fees and expenses, the focus of this Subpart, are a common form of recent litigation and raise both duty of disclosure and duty of prudence issues.<sup>300</sup> Fiduciaries have an obligation to administer plan duties with reasonable fees and must attempt to defray unnecessary fees as a part of their prudence obligation.<sup>301</sup> The essence of fee litigation cases is that “the [plan] fiduciaries had an obligation to avoid higher than necessary fees in the mutual fund options offered in a plan menu, and failed to do so.”<sup>302</sup> For the most part, administrative fees associated with self-directed defined contribution plans<sup>303</sup> are borne by plan participants, one of the many shifts from employer to employee responsibility that occurs in our defined contribution society.<sup>304</sup> Fee litigation

300. Adams, *supra* note 239, at 353 (“Confusion about the extent of the duty of disclosure and the role of the duty of prudence manifests itself in excessive fee and revenue-sharing cases.”).

301. ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A)(ii) (2006).

302. Stephen D. Rosenberg, *Retreat from the High Water Mark: Breach of Fiduciary Duty Claims Involving Excessive Fees After Tibble v. Edison International*, J. PENSION BENEFITS, Spring 2011, at 12, 13.

303. Fees and expenses include one-time load fees such as front-end (a percentage deduction at the time of purchase) and back-end fees (a percentage deduction at the time of withdrawal) that essentially act as a transaction commission. *Mutual Fund Fees and Expenses*, SEC (Jan. 15, 2013), <http://www.sec.gov/answers/mffees.htm> (describing common fees and expenses charged with mutual fund investments). The second category is annual expenses, also called expense ratios, which are 12b-1 fees and management fees paid to investment advisors for overseeing the fund’s portfolio. *Id.* 12b-1 fees include distribution fees and shareholder service expenses. “Distribution fees’ include fees paid for marketing and selling fund shares, such as compensating brokers and others who sell fund shares, and paying for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature.” *Id.* Shareholder services expenses include “fees paid to persons to respond to investor inquiries and provide investors with information about their investments.” *Id.*; see also MUNNELL & SUNDÉN, *supra* note 6, at 77 (describing 12b-1 fees as “annual fees paid out of fund assets to cover commissions to salespersons and brokers, advertising costs, and other services” ranging between “0.25 percent and 1.0 percent of assets”).

304. See, e.g., *Advisory Opinion Guidance: Guidance on Settlor v. Plan Expenses*, DEPT OF LABOR, [http://www.dol.gov/ebsa/regs/AOs/settlor\\_guidance.html](http://www.dol.gov/ebsa/regs/AOs/settlor_guidance.html) (last visited Sept. 20, 2013) [hereinafter *Advisory Opinion Guidance*] (responding to questions concerning the extent that plans may pay expenses that could be viewed as conferring a benefit on the plan sponsor).

Employers sometimes confuse plan-related business expenses—which aren’t payable from plan assets—with plan administration expenses. The U.S. Department of Labor (DOL) has long held that costs incurred to design, establish, and terminate plans—so-called ‘settlor functions’—are not reasonable expenses of administering a plan. These expenses are incurred for the benefit of the employer and involve services the employer can



cases highlight the limitation of participant *choice* and how the plan structure, established by the employer and other fiduciaries, significantly impacts plan performance.<sup>305</sup> The fee litigation cases illustrate the substantive limits of fiduciary duties as applied to citizen shareholders, who are precluded from protection on decisions that substantially impact participants' choice and individual savings.<sup>306</sup>

Plan fees and expenses are a crucial element of any plan and have great impact on plan performance because high fees diminish plan savings and earnings over time.<sup>307</sup> The relationship between fees/expenses and fund performance is the basis of such claims—that a failure to reduce fees and expenses substantially impacts the accumulated retirement savings available to participants.<sup>308</sup> Under the terms of the self-directed defined contribution plan, participants have control over the allocation of their accounts to various investment options offered, but no control over the fees and expenses charged for each option.<sup>309</sup> Participants therefore rely

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reasonably be expected to pay in the normal course of its business operations.

*Baden Retirement Plan Services*, BENEFITS ADVANTAGE, <http://www.badenrps.com/document-view/benefits-advantage-fall-2009> (last visited Sept. 20, 2013).

305. See John J. Topoleski, *Fee Disclosure in Defined Contribution Retirement Plans: Background and Legislation*, CONG. RES. SERVICE 1 (Jan. 29, 2010), available at <http://www.aging.senate.gov/crs/pension37.pdf> (noting that small differences in the fees charged to 401(k) plan participants can “yield large differences in account balances at retirement”); *Advisory Opinion Guidance*, *supra* note 304 (identifying how plan performance is impacted by employer choices in various hypothetical scenarios).

306. Topoleski, *supra* note 305, at 1–2.

307. Rosenberg, *supra* note 302, at 13 (“The interrelated problem for plan participants, however, and which amplifies the risk posed to participants by high fees, is the corollary finding that higher fees do not correspond to equivalently higher returns under mutual funds, which make up much of the investment menu open to 401(k) plan participants.”).

[T]he market mechanism might be inefficient in the market for advice. Advice markets suffer by definition from information asymmetries between providers and recipients. In markets with inattentive consumers and shrouded attributes, perverse situations with high fees can persist as bona fide economic equilibria when there are enough naive consumers and the only profitable business model is to offer a product with low base prices and high “surprise” fees . . . . Are professional fiduciaries trustworthy or not? There is much anecdotal evidence of problems, for example of outrageously high fees, but a systematic quantification is needed.

Agarwal et al., *supra* note 58, at 92–93 (citations omitted).

308. “[T]he amount of fees contained in mutual funds or other investment options in a 401(k) plan significantly impacts the long-term outcome for plan participants.” Rosenberg, *supra* note 302, at 13.

309. *Id.*

A compounding . . . problem for both plan participants and fiduciaries is that, under the operation of a 401(k) plan, large numbers of plan participants are limited to the investment options provided in a plan menu. . . . [P]lan participants have limited, if any, control over the fees they

upon fiduciaries to monitor and evaluate the costs associated with plan investments.

Many fee cases also address the related problem of revenue sharing where a portion of fees charged on the mutual fund options are used to offset administrative costs of the plan.<sup>310</sup> Under a revenue sharing arrangement in defined contribution plans, high plan fees “reduce or effectively eliminate the plan [employer’s] own costs in offering a 401(k) plan . . . .”<sup>311</sup> Because high fees erode individual account savings, revenue sharing “creates a potential tension between the short-term financial interests of the plan sponsor and the long-term financial interests of plan participants,” which if proven could create the basis for a breach of fiduciary duty of loyalty claim.<sup>312</sup>

Additionally, revenue sharing practices were the basis of duty of disclosure claims where the plaintiffs argued that employers failed to adequately disclose the nature and extent of the revenue sharing arrangements.<sup>313</sup> DOL final rules, proposed in February 2012, require additional participant disclosures regarding administrative fees, individual expense information, and quarterly statements “showing the dollar amount of the plan-related fees and expenses (whether ‘administrative’ or ‘individual’) actually charged to or deducted from their individual accounts, along with a description of the services for which the charge or deduction was made.”<sup>314</sup> The DOL rules clarified obligations for disclosing revenue sharing practices. If

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pay to invest for retirement. . . . They are . . . at the mercy of the . . . decisions made by the plan’s fiduciary.

*Id.*

310. *Id.* (“Many so-called ‘excessive fee’ claims also attack the alleged problem of revenue sharing, in which a portion of the fees in the mutual fund options themselves are used to fund the administration of the plan.”).

311. *Id.*

312. *Id.*

313. The Eighth Circuit refused to declare that revenue sharing and disclosures related thereto could not be the basis of a breach of fiduciary duty claim. Finding those types of claims to be “fact and context sensitive” and should not be decided as a matter of law. *Braden v. Wal-Mart Stores*, 588 F.3d 585, 600 (8th Cir. 2009).

314. 29 C.F.R. § 2550.404a-5(c) (2012); *Fact Sheet*, *supra* note 187. Beginning in 2009, employer sponsors were also required to disclose revenue sharing practices on form 5550 filed with the DOL to include

- (1) identifying information for all direct and indirect compensation over \$5000,
- (2) the types of services being provided, (3) the relationship of the service provider to the plan and any party in interest, (4) whether the indirect fees are eligible or ineligible indirect compensation, and (5) whether any service provider failed or refused to provide the fee disclosure information necessary to complete Schedule C.

Kathryn L. Moore, *401(k) Plan Fees: A Trifecta of Governmental Oversight*, in NYU REVIEW OF EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION 17-1, 17-5 to 17-6 (Alvin Lurie ed., 2009) (citations omitted).

employer sponsors comply with DOL disclosure rules for revenue sharing practices, they will avoid disclosure-based liability.

A trio of recent cases explored fiduciary liability for high fees charged by plan trustees and the investment advisors,<sup>315</sup> which were passed through by employers as well as revenue-sharing practices<sup>316</sup> between the fiduciaries. In the 2009 case of *Hecker v. Deere & Co.*, the Seventh Circuit was the first appellate court to rule on the excessive fee issue. At issue in the case was whether the employer violated its fiduciary duties to participants by offering investment options with excessive fees and not disclosing a revenue sharing provision between it and the plan administrators.<sup>317</sup> The excessive fee claim that remained against the employer alleged that the fees charged to participants were the same as those paid by retail

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315. Ultimately, the court denied employer liability finding that the participants were advised of the total fee amounts charged to each account and that participants were able to select lower fee alternatives available through an open broker window that offered over 2,500 retail mutual funds. *Hecker v. Deere & Co.*, 556 F.3d 575, 586, 590 (7th Cir. 2009); see also Jeffrey D. Mamorsky, *DOL Fee Disclosure Regulations and Litigation Creates Havoc for Plan Sponsor Fiduciaries*, J. COMPENSATION & BENEFITS, Sept./Oct. 2012, at 1 (discussing recent litigation about fiduciary duties and high plan fees charged to participants). In 2009, the Eighth Circuit reversed a dismissal of excessive fee claims in *Braden v. Wal-Mart Stores*. *Braden*, 588 F.3d at 589. The court concluded that the plaintiff alleged sufficient facts to withstand dismissal and remanded the case. *Id.* at 595. Among these facts were that plan funds charged high market fees while underperforming, that all fees were paid by plan assets and thus depleted retirees' accounts, that participants were charged retail fees, that fees were not evaluated in plan selection, and that the revenue sharing arrangement was not adequately disclosed. *Id.* at 598–99. A 2012 district court case evaluating similar issues determined that if a fiduciary is paid via revenue sharing, "it must also have gone through a deliberative process for determining why such a choice is in the Plan's and participants' best interest." *Tussey v. ABB, Inc.*, 2:06-CV-04305-NKL, 2012 WL 1113291, at \*16 (W.D. Mo. Mar. 31, 2012), amended in part sub nom. *Tussey v. ABB Inc.*, 06-4305-CV-C-NKL, 2012 WL 2368471 (W.D. Mo. June 21, 2012), reconsideration denied, 2:06-CV-04305-NKL, 2012 WL 5512389 (W.D. Mo. Nov. 14, 2012) (pending on appeal before the Eighth Circuit). The district court found after a four-week bench trial that the employer sponsor failed to reasonably monitor the expenses paid by participants in breach of the fiduciary obligation to do so. *Id.* at \*35. The employer sponsor failed to calculate the total amount paid for recordkeeping fees, was unaware that it could leverage the plan's size, was informed by an outside consultant that it was paying too much for fees, had not determined if it was paying a favorable rate for administrative services, and was unaware of general market prices for "comparable recordkeeping fees". *Id.* at \*10.

316. Many fee cases also address the related problem of revenue sharing "in which a portion of the fees in the mutual fund options themselves are used to fund the administration of the plan." Rosenberg, *supra* note 302, at 13; see also *Hecker*, 556 F.3d at 586. Under a revenue sharing arrangement in defined contribution plans, high plan fees "reduce or effectively eliminate the plan [employer's] own costs in offering a 401(k) plan . . ." Rosenberg, *supra* note 302, at 13. Because high fees erode individual account savings, revenue sharing therefore "creates a potential tension between the short-term financial interests of the plan sponsor and the long-term financial interests of plan participants" which if proven could create the basis for a breach of fiduciary duty of loyalty claim. *Id.*

317. *Hecker*, 556 F.3d at 578.

investors who invest individually and outside of a specific plan.<sup>318</sup> For example, if an individual investor purchased mutual fund shares through eTrade, the “retail” investor would have been charged the same administrative fees and expenses as a participant in the employer-sponsored plan. The argument here is analogous to buying group health insurance because group purchases through an employer-sponsored plan should yield lower premiums for participants than an individual going to the market to obtain private health insurance.<sup>319</sup> The plaintiffs argued that paying retail fees was excessive in the context of the bulk buying power in an employer-sponsored plan.<sup>320</sup>

Revenue sharing claims, on the other hand, challenged how the fees were paid, not the amount of the fee.<sup>321</sup> The plaintiffs also alleged that Fidelity Research, the plan advisor, shared its revenue earned from mutual fund fees with Fidelity Trust, the plan trustee.<sup>322</sup> Fidelity Trust applied the fee revenues to administrative expenses rather than charging Deere directly for its services.<sup>323</sup> The basic argument with revenue sharing claims is that participants were charged higher fees in order to offset administrative service fees that would otherwise have been paid by the employer-sponsor.<sup>324</sup>

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318.

Importantly, all of these funds were also offered to investors in the general public, and so the expense ratios necessarily were set against the backdrop of market competition. The fact that it is possible that some other funds might have had even lower ratios is beside the point; nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems).

*Id.* at 586.

319. Steve Sternberg, *Mistakes to Avoid When Buying Health Insurance*, U.S. NEWS & WORLD REPORT (Aug. 7, 2012), <http://health.usnews.com/health-news/health-insurance/articles/2012/08/07/mistakes-to-avoid-when-buying-health-insurance>.

320. *Hecker*, 556 F.3d at 579 (“None of the Fidelity Research funds operated exclusively for Deere employees; all were available on the open market for the same fee.”).

321. *Id.* at 585.

322. *Id.* at 578.

323. *Id.*

The Hecker group alleges that Fidelity Research shared its revenue, which it earned from the mutual fund fees, with Fidelity Trust. Fidelity Trust in turn compensated itself through those shared fees, rather than through a direct charge to Deere for its services as trustee. As the Hecker group sees it, this led to a serious—in fact, impermissible—lack of transparency in the fee structure, because the mutual fund fees were devoted not only to the (proper) cost of managing the funds, but also to the (improper) cost of administering Deere’s 401(k) plans.

*Id.*

324. *Id.* at 579; see also *Tussey v. ABB, Inc.*, No. 2:06-CV-04305-NKL, 2012 WL 1113291, at \*9 (W.D. Mo. Mar. 31, 2012) (explaining that participants pay for revenue sharing expenses because such expenses are paid from the investment’s assets). The prospectus for each

The Seventh Circuit concluded, however, that high retail fees did not breach a fiduciary duty because participants were offered alternative investment options through an open brokerage window and therefore were not necessarily required to pay the high fees.<sup>325</sup> Thus, variety in investment options cured the high retail fees paid in the traditional, and most selected, options.<sup>326</sup> Similarly, the court held that revenue sharing of administrative fees did not breach a fiduciary duty and that there was no duty to disclose the fee-sharing relationship.<sup>327</sup> As noted above, DOL regulations have since expanded employer disclosure obligations with regard to revenue sharing practices requiring quarterly statements of actual expenses charged to individual accounts.<sup>328</sup>

Later in 2009, the Eighth Circuit reversed a dismissal of excessive fee claims in *Braden v. Wal-Mart Stores*.<sup>329</sup> The complaint raised several specific claims which collectively alleged a breach of fiduciary duty by the employer for failing to adequately “evaluate the investment options included in the Plan” and challenged the process by which funds were selected for inclusion in the plan, asserting that high fees and revenue sharing practices influenced final decisions.<sup>330</sup> The Eighth

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investment includes an expense ratio which affects the net asset value of investments. Investment expenses are paid from the assets of the investment, and therefore investors themselves pay the investment’s expenses. *Id.* When those expenses are shared with other plan administrators and cover such expenses as recordkeeping or trustee services, the practice is called revenue sharing. Like other aspects of the defined contribution model, here the administrative costs of the plan are shifted away from the employer sponsor to the employee participant. *Id.*

325. *Hecker*, 556 F.3d at 586.

326. The plan investments provided by Deere included “23 different Fidelity mutual funds, two investment funds managed by Fidelity Trust, a fund devoted to Deere’s stock, and a Fidelity-operated facility called BrokerageLink, which gave participants access to some 2,500 additional funds managed by different companies.” *Id.* at 578.

327. *Id.* at 585–87.

328. 29 C.F.R. § 2550.404a-5(c) (2012).

The long-awaited and recently finalized fee disclosure regulations are likely to add fuel to the excessive fee case trend . . . . The new regulations . . . require “transparency of fees” by service providers in order to better enable plan fiduciaries to select among them . . . . In view of the DOL’s stated rationale of requiring more transparency of fees and the industry’s resistance to providing anything more than the currently disclosed expense ratio, the arena of required fee disclosure is likely to be a hotbed of disputes to come.

Capobianco & Jara, *supra* note 49, at \*5.

329. *Braden v. Wal-Mart Stores, Inc.*, 588 F.3d 585, 589–90 (8th Cir. 2009).

330.

Braden filed his complaint . . . alleging five causes of action against Wal-Mart and the individual appellees, executives serving on or responsible for overseeing the Retirement Plans Committee. The gravamen of the complaint

Circuit concluded that the plaintiff alleged sufficient facts to withstand dismissal and remanded the case.<sup>331</sup> Among these facts were that plan funds charged high market fees while underperforming, that all fees were paid by plan assets and thus depleted retirees' accounts, that participants were charged retail fees, that fees were not evaluated in plan selection, and that the revenue sharing arrangement was not adequately disclosed.<sup>332</sup> The parties reached a settlement agreement in December 2011, when the defendants agreed to pay over \$13.5 million in damages and make changes to the plan, including increased participant education, decreased retail-fee charging investment options, and enhanced fee disclosures consistent with proposed DOL regulations.<sup>333</sup>

A 2012 district court case evaluating similar issues determined that if a fiduciary is paid via revenue sharing, "it must also have gone through a deliberative process for determining why such a choice is in the Plan's and participants' best interest."<sup>334</sup> Once again the revenue sharing practices between Fidelity Trust and Fidelity Research were at issue.<sup>335</sup> The district court found after a four-week bench trial that the employer sponsor failed to reasonably monitor the expenses paid by participants in breach of the fiduciary obligation to do so.<sup>336</sup> The employer sponsor failed to calculate the total amount paid for recordkeeping fees, was unaware that it could leverage the plan's size, was informed by an outside consultant that it was paying too much for fees, had not determined if it was paying a favorable rate for administrative services, and was unaware of general market prices for "comparable recordkeeping fees."<sup>337</sup>

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is that appellees failed adequately to evaluate the investment options included in the Plan. It alleges that the process by which the mutual funds were selected was tainted by appellees' failure to consider trustee Merrill Lynch's interest in including funds that shared their fees with the trustee. The result of these failures . . . is that some or all of the investment options included in the Plan charge excessive fees.

*Id.*

331. *Id.* at 591.

332. *Id.* at 598–99.

333. William P. Barrett, *Walmart, Merrill Lynch Agree to Pay \$13.5 Million to Settle 401(k) Fiduciary Lawsuit*, FORBES (Dec. 5, 2011, 6:10 PM), <http://www.forbes.com/sites/williamphbarrett/2011/12/05/walmart-merrill-lynch-agree-to-pay-13-5-million-to-settle-401k-fiduciary-lawsuit/>.

334. *Tussey v. ABB, Inc.*, No. 2:06-CV-04305-NKL, 2012 WL 1113291, at \*16 (W.D. Mo. Mar. 31, 2012).

335. *Id.* at \*1–2.

336. *Id.* at \*2, \*10.

337. *Id.* at \*10.

Failure of oversight in light of plan statements that revenue sharing would be used to “offset or reduce recordkeeping costs” resulted in a breach of fiduciary duty.<sup>338</sup> Employers cannot be blind to costs that do not result in an increase in their own expenses.<sup>339</sup> The district court cautioned employers that “[w]hile revenue sharing is accepted industry-wide as a method of paying for plan recordkeeping services, the prudence of choosing that option must be evaluated according to the circumstances of each plan.”<sup>340</sup> The employer also breached duties when it removed low-fee options and replaced them with higher fee options motivated, at least in part, by increasing revenue sharing to cover administrative expenses.<sup>341</sup> Specifically, the court found that the duty of prudence was violated “(1) when they failed to follow the IPS when it considered only two viable options for a managed allocation fund, and (2) failed to engage in a deliberative assessment of the merits when determining which investment option to choose.”<sup>342</sup>

Defined contribution participants’ “choice” in self-directed plans regarding investment allocation restricts the scope of the traditional ERISA fiduciary protections under the safe harbor.<sup>343</sup> These cases illustrate the limitations of investor choice in defined contribution plans and highlight the continued control exercised by employers and other plan fiduciaries with significant impact on individual retirement savings. Employers and other plan fiduciaries exercise structural control over plans, which warrants oversight but is difficult to achieve due to the narrow scope of liability for fiduciaries of defined contribution plans. These cases highlight the limited grounds on which plaintiffs can raise breach of fiduciary duty claims in relationship to fees, the lack of a

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338. *Id.* at \*10–11.

339. “[W]ithout calculating the dollar amount of the recordkeeping fees, ABB could not know whether revenue sharing was offsetting or reducing the cost. . . . ABB’s monitoring of the reasonableness of the overall expense ratio was insufficient because it does not show how much revenue is flowing, does not show the competitive market for comparable funds, and fails to take into account the size of the plan.” Mamorsky, *supra* note 315, at 1–2.

340. *Tussey*, 2012 WL 1113291 at \*15.

341. *Id.* at \*21 (“[T]he Vanguard Wellington Fund with its low fees, and long-standing consistent performance history, made it a very attractive fund . . . . The Court believes that the Wellington Fund’s removal was not due to any failure of its merits, but because the Freedom Funds that replaced it generated more in revenue sharing for Fidelity Trust.”).

342. *Id.* at \*22.

343. Maher & Stris, *supra* note 88, at 459 n.129.

cohesive approach to fees in federal courts, and the impact structural decisions have on participant options, and in many cases, their retirement savings outcomes.

## VI. SUGGESTED REFORMS AND CONCLUSIONS

Citizen shareholders bear traditional investment risks that all shareholders face—rising or falling stock market—but citizen shareholders shoulder those risks in the context of limited accountability mechanisms. The shift from defined benefit to defined contribution plans, the emergence of self-directed retirement accounts, and the resulting dependence on the stock market, particularly mutual and index funds, created our defined contribution society where employees bear significant retirement risks. ERISA's regulatory framework is not focused on and does not mitigate these new risks. To help balance these risks borne by citizen shareholders, ERISA regulations should focus on both structural and individual reforms.

### A. *Structural Reforms*

Structural reforms focus on how citizen shareholders invest in the market and the regulatory environment protecting them.<sup>344</sup> The following is a brief discussion of possible structural reforms including strengthening fiduciary duties for structural plan decisions, especially those related to fees and expenses, evaluating the fractured oversight and implementation of ERISA, and examining the role of intermediaries in self-directed defined contribution plans. The suggestions provided below are a starting point for thinking about reforms, a complete discussion of which is beyond the scope of this paper.

Re-evaluating the substantive barriers to fiduciary duty oversight is a key area of structural reform. The fee litigation cases illustrate the control that plan fiduciaries continue to exercise over self-directed defined contribution plans.<sup>345</sup> Since participant *choice* is the basis for applying the safe harbor exemption, structural decisions that restrict and impact participants' choice should be subject to the full scope of fiduciary duties as originally conceived of in ERISA, not the safe harbor applied to self-directed accounts. This is particularly relevant in

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344. For instance, rules promulgated by the IRS regarding automatic enrollment impact how citizens shareholders invest because they are more likely to invest. And rules released by the DOL regarding disclosures focus on the regulation of retirement plans. See *infra* note 365 (explaining the IRS automatic enrollment rules and DOL disclosure rules).

345. See *supra* Part V.C.2 (discussing fee litigation cases).



light of information asymmetries and financial illiteracy that call into question participants' ability to effectively evaluate the impact that fees have on long-term savings goals.<sup>346</sup> High fees, especially when they serve as a means to offset administrative costs of plan sponsors (employers), exacerbate these information asymmetries and the risks borne by participants. Additionally, reliance on open-market investment alternatives like those offered in open brokerage window options fail to cure the structural defect or consequence of high fees. The endorsement bias for the twenty or so funds offered within a self-directed defined contribution plan make those options, despite the high fees, attractive to many participants.<sup>347</sup> Additional behavior biases such as inertia, immobilization and procrastination<sup>348</sup> make the brokerage window a theoretically unattractive option for many participants who feel ill-equipped to make investment decisions.<sup>349</sup> Brokerage window accounts should not be allowed to create the illusion of choice and therefore allow the safe harbor affirmative defense to apply to other structural decisions.

Another area of structural ERISA reforms for citizen shareholders involves the fractured oversight of self-directed defined contribution plans. Three major agencies—the DOL, the SEC, and the IRS—are tasked with various functions under ERISA.<sup>350</sup> Congress designated the DOL, acting through the

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346. See Barr & Diamond, *supra* note 207, at 8–9.

In the context of pensions, there is ample evidence of poor information . . . [V]irtually nobody realizes the significance of administrative charges for pensions . . . [O]ver a full career, an annual management charge of 1 percent of the individual's accumulation reduces the accumulation (and hence the pension) by 20 percent.

*Id.*

347. See Medill, *supra* note 33, at 335–36 (explaining how investors will reduce information costs by selecting “heavily marketed, broker-sold investment funds, even though those funds have higher fees”).

348. “Recent lessons from behavioral economics also yield powerful lessons, explaining such phenomena as procrastination (people delay saving, do not save, or do not save enough), inertia (people stay where they are), and immobilization (whereby conflicts and confusion lead people to behave passively, like a deer in the headlights).” Barr & Diamond, *supra* note 207, at 9.

349. Note that there is no current data for the number of self-directed defined contribution participants who opt for open-brokerage window investment allocations nor for the amount of money invested in these vehicles relative to all defined contribution dollars.

350. ERISA regulations govern all benefit plans and the oversight agencies that implement and enforce ERISA standards. The DOL acts primarily through the Employee Benefits Security Administration (EBSA) and the U.S. Department of Treasury through the IRS. KOZAK, *supra* note 4, at 31. The PBGC, a third regulatory agency over ERISA, oversees Title IV of ERISA dealing with insurance and guarantees defined benefit plans. “PBGC was created . . . to encourage the continuation and maintenance of private-sector defined benefit pension plans, provide timely and uninterrupted payment of pension

Employee Benefits Security Administration (EBSA), as the primary regulatory agency for enforcing ERISA standards related to plan reporting and disclosures, fiduciary duties, plan administration, and private enforcement actions.<sup>351</sup> The DOL is also responsible for financial education of employees, a task that is not mandated under ERISA regulations but serves an important role in the retirement framework, especially for self-directed defined contribution plans.<sup>352</sup> In addition to the IRS, which administers Title II of ERISA,<sup>353</sup> the SEC regulates the sale and reporting requirements for the investments offered in self-directed defined contribution plans.<sup>354</sup> Regulatory authority, interpretations and enforcement are spread across several agencies complicating the process for citizen shareholders as well as employers to navigate.<sup>355</sup> Additionally, the fractured regulatory landscape reduces the priority that any one agency can make ERISA policy development, oversight, or enforcement.<sup>356</sup>

The issues addressed in each agency's silo—workplace, tax, or securities—have implications in the other arenas as well. For example, the SEC proposed advertising rule amendments related to target-date funds, popular mutual fund products, requiring companies to include the date in the fund

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benefits, and keep pension insurance premiums at a minimum.” *Who We Are*, PBGC, <http://www.pbpc.gov/about/who-we-are.html> (last visited Sept. 20, 2013).

351. Medill, *supra* note 33, at 327. Thus, the EBSA carries out the DOL's responsibilities under ERISA Title I. *History of EBSA and ERISA*, DEP'T OF LABOR, <http://www.dol.gov/ebsa/aboutebsa/history.html> (last visited Sept. 20, 2012). At the time of its name change in February 2003, “EBSA was known as the Pension and Welfare Benefits Administration (PWBA). Prior to January 1986, PWBA was known as the Pension and Welfare Benefits Program.” *Id.*

352. See Medill, *supra* note 33, at 341–42 (discussing the DOL's role as the primary agency responsible for financial education of employees and criticisms regarding the limitations of DOL's efficacy in that role). Additionally, there are “four federal regulatory agencies involved in educating the public to save and invest for retirement. In addition to the DOL, the Securities and Exchange Commission (SEC) and the Department of the Treasury also have public education initiatives, as does the Social Security Administration.” *Id.* at 348 (footnotes omitted).

353. The IRS administers Title II of ERISA, regarding funding, vesting, and minimum payments as well as overseeing the tax-exempt and tax-deferred components of pension benefits. KOZAK, *supra* note 4, at 31, 34. In 1978 President Jimmy Carter issued an Executive Statement reorganizing jurisdiction under ERISA as between the DOL and the DOT. Reorganization Plan No. 4 of 1978, 43 Fed. Reg. 47,713 (1978), *reprinted in* 5 U.S.C. app. at 297–99 (Supp. II 1976), and in 92 Stat. 3793 (1978); see also KOZAK, *supra* note 4, at 33–35.

354. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC, <http://www.sec.gov/about/whatwedo.shtml> (last visited Sept. 20, 2013).

355. See KOZAK, *supra* note 4, at 32–35 (discussing the various federal agencies with the authority to issue regulations and interpretations under ERISA).

356. See *id.* (discussing how the Department of Treasury and DOL may issue regulations that carry the force of law; however, that does not give priority to one agency over the other).

name and provide a description of the asset allocation within the fund.<sup>357</sup> The SEC focused on target-date funds because of the decline of defined benefit pensions and the growth of the defined contribution society where “Americans are increasingly responsible for constructing and managing their own retirement portfolios,” a task that can be “challenging” and require “significant knowledge and commitment of time.”<sup>358</sup> These additional disclosures, while beneficial, do not address the broader issue of how to provide employees with comparative disclosures of their investment options within a given plan in a way that will help them choose the appropriate investment vehicle and actively manage their accounts.<sup>359</sup> There is little coordination among the SEC’s advertising rules and the DOL’s investor education programs or reporting requirements.<sup>360</sup> Fractured oversight, implementation, and enforcement limit the effectiveness of any single agency’s efforts within its individual silo.<sup>361</sup> The workplace, tax, and securities policies related to citizen shareholders should be considered in a dedicated, consolidated agency vested with policy development, implementation, education, oversight, and enforcement of self-directed defined contribution plans.

Another area of potential structural reform may be found in closely examining the role of institutional investors (i.e., mutual and index funds) as well as other intermediaries such as investment brokers and advisors who facilitate citizen shareholders’ investments, who benefit directly from fee arrangements and who represent the interests of citizen shareholders in the private securities market. A subsequent article focusing more extensively on the role of corporate governance and securities statutes will scrutinize the role of intermediaries in our defined contribution society.<sup>362</sup>

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357. Investment Company Advertising: Target Date Retirement Fund Names and Marketing, 75 Fed. Reg. 35,920 (proposed June 23, 2010) [hereinafter Investment Company Advertising] (to be codified at 17 C.F.R. pts. 230 & 270), available at <http://www.sec.gov/rules/proposed/2010/33-9126.pdf>; see also Investment Company Advertising: Target Date Retirement Fund Names and Marketing, 75 Fed. Reg. 35,920 (proposed Apr. 6, 2012) (to be codified at 17 C.F.R. pts. 230 & 270), available at <http://www.sec.gov/rules/proposed/2012/33-9309.pdf> (reopening the comment period in 2012 in response to an SEC-sponsored survey on TDF disclosures).

358. Investment Company Advertising, *supra* note 357, at 35,920.

359. See *infra* text accompanying note 387 (suggesting disclosures should be simplified and consolidated because too much information can create “noise” ignored by investors).

360. For instance, the DOL released guidelines on its reporting requirements; however, these guidelines do not incorporate the reporting requirements of the IRS. *Reporting and Disclosure Guide for Employee Benefit Plans*, DOL 1 (Oct. 2008), <http://www.dol.gov/ebsa/pdf/rdguide.pdf>.

361. *Id.*

362. See *supra* note 34.

Some risks borne by participants under our defined contribution society cannot be fully mitigated. Market performance, for example, is a risk some party in the framework has to bear.<sup>363</sup> Public guarantee options may not be the silver-bullet solution when the PBGC is notoriously underfunded.<sup>364</sup> The discussion of shifting risks of self-directed systems that in turn link individual financial security with the performance of private securities markets may have application to broader policy debates such as social security reform and questions of privatization.

### B. Individual Reforms

Reforms focused on the individual participant are needed to mitigate some of the risks shifted onto citizen shareholders in our defined contribution society and better prepare participants to assume the retirement savings responsibility required for individual and national financial security. Reforms focused on individuals should tackle several existing deficiencies within the ERISA framework such as contribution defaults, investor disclosures, and financial literacy.

To claim that ERISA has been wholly unresponsive to the retirement revolution and the prevalence of the self-directed defined contribution plans would be an overstatement. ERISA has incorporated limited reforms that are intended to ease the burden of individual management of retirement accounts. These reforms include automatic enrollment default rules in 401(k) plans and efforts at reforming participant disclosures.<sup>365</sup> The market has also been somewhat responsive. The evolution of target date retirement funds was in direct response to the problem of self-directed defined contribution plans where participants had no desire and/or confidence in his or her ability to actively manage retirement savings.<sup>366</sup> Target date funds are a

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363. See THE PALGRAVE DICTIONARY OF MONEY AND FINANCE 358 (Newman et al. eds., 2d ed. 1992) (describing risk as having a “pervasive role in economic life”); see also *supra* notes 167–68 and accompanying text (discussing how market performance risk shifted from employers to employees).

364. See PBGC, ANNUAL REPORT 2012, at 24 (2012), <http://www.pbtc.gov/documents/2012-annual-report.pdf> (stating that the PBGC’s overall financial position has declined and the deficit increased to \$34.38 billion as of September 30, 2012).

365. See MUNNELL & SUNDÉN, *supra* note 6, at 63 (“In 1998 and 2000 the Internal Revenue Service (IRS) issued regulations that allow employers to enroll employees automatically . . . .”); see also *Fact Sheet*, *supra* note 187 (providing an overview of new DOL rules relating to disclosures of plan-related information).

366. Investment Company Advertising, *supra* note 357, at 35,921 (“Target date retirement funds . . . are designed to make it easier for investors to hold a diversified portfolio

“hybrid” fund that allocates investments based upon a risk formula that is calculated according to an estimated retirement date (i.e., the target date) of the participant.<sup>367</sup> These initial responses improved the risk balance in participants’ favor, but do not set the correct balance of risk mitigation and management. These developments are built upon in the following suggestions discussed below.

1. *Sticky Defaults and Nudges.* Self-directed defined contribution plans may offer a default option of automatic enrollment, meaning that an employee is automatically enrolled to participate in the 401(k) with an opt-out option, rather than requiring the employee to opt into the plan to participate.<sup>368</sup> Automatic enrollment eliminates some of the procrastination and inertia problems that individuals may have with starting retirement savings.<sup>369</sup> Automatic enrollment does not eliminate those problems with regard to account management.<sup>370</sup> The default contribution rates and allocations under automatic enrollment are not ideal for participants and do not sufficiently mitigate the risks shifted onto them in self-directed defined contribution plans. Reliance on default contribution rates and allocations highlight the concept of “sticky defaults,” where employees do the least to actively manage their retirement accounts and “stick” in the default options.<sup>371</sup> For example, participants through automatic

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of assets that is rebalanced automatically among asset classes over time without the need for each investor to rebalance his or her own portfolio repeatedly.”).

367. INV. CO. INST., *supra* note 2, at 120. Target date funds are also known as lifestyle funds. *Id.* at 235, 240.

368. For a discussion of automatic enrollment in 401(k) plans, see Medill, *supra* note 33, at 333.

369. MUNNELL & SUNDÉN, *supra* note 6, at 65 (“[A]utomatic enrollment has a dramatic effect on employee participation rates, with the largest increases among groups that benefit the most: low-income workers.”); *see also* Sunstein, *supra* note 148, at 1393 (noting that after automatic enrollment, 401(k) participation increased even though opting out of it was easy).

370. *See* Medill, *supra* note 33, at 333 (explaining that automatic enrollment plans increase employee participation, but employees usually do not increase their contribution levels, even when wages are increased).

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[T]he problem of sticky defaults explains why participation rates in 401(k) plans can be improved dramatically by changing the ‘default’ option from nonparticipation to participation in the plan through an automatic enrollment feature. It also explains why workers who are automatically enrolled in 401(k) plans tend to ‘stick’ at the contribution levels assigned by their employers rather than increasing their contribution levels over time as their wages increase, and tend to remain in the default investment option assigned by their employers, such as ‘safe’ but low-earning money market funds.

*Id.*

enrollment have lower than average savings “because workers tend to stay with the low default contribution rates.”<sup>372</sup> Participants are also likely to stay in the original asset class assignment provided with automatic enrollment, which may be a money market or other low-yield allocation.<sup>373</sup>

In light of the success of automatic enrollment promoting participation and the trap of sticky defaults, such as low contribution rates and low-yield investment allocations, participants could be provided with other risk-mitigating nudges in the form of defaults and prompts. For example, contribution default reforms, with opt-out options, could increase the minimum savings for most participants by automatically increasing contribution levels with salary increases or at a gradual annual rate until a minimum recommended savings level (i.e., 6% or more) is achieved.

Additionally, requiring annual investment reallocations could address the problem of assets permanently remaining in default, low-yield allocations. For example, participants could be required to reallocate within one year or be placed in a target-date fund.<sup>374</sup> Additionally participants could be asked to provide a preferred allocation between asset classes such as money-market funds, bonds, mutual funds, etc. An employee could opt for 70% in mutual funds, 20% in bonds, and 10% in money-market funds. The account would be automatically reallocated annually to maintain the default asset class diversification specified at

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372. MUNNELL & SUNDÉN, *supra* note 6, at 65. “Several papers have recognized that default contribution rates that are too low may prevent workers from accumulating enough retirement wealth, taking advantage of employer-matching contributions, and exploiting the tax advantages of investing in pension assets.” Lusardi, *supra* note 183, at 134.

373. MUNNELL & SUNDÉN, *supra* note 6, at 91. Money market funds invest in “short-term, high-grade fixed-income securities, and seek[] the highest level of income consistent with preservation of capital (i.e., maintaining a stable share price).” INV. CO. INST., *supra* note 2, at 236. Money market funds have low yields, averaging as low as 0.03% because of low short-term interest rates. Walter Updegrave, *Are Money-Market Accounts and Funds the Same?*, CNN MONEY, (June 13, 2012, 5:17 AM), <http://money.cnn.com/2012/06/13/pf/expert/money-market-funds.moneymag/index.htm>.

Money-market funds are designed to maintain a stable price of \$1 per share with each dollar of interest you collect earning you an additional share of the fund.

But there’s no guarantee that a money-fund’s share value won’t sink below \$1. And, in fact, after decades of a nearly flawless record of money funds preserving a \$1 per share value, in September 2008, the Reserve Primary Fund ‘broke the buck,’ or let its share price slip below \$1, after suffering losses on Lehman Brothers debt it owned.

*Id.*

374. Target date funds can be the default option in automatic enrollment self-directed defined contribution plans. Craig Copland, *Target-Date Fund Use in 401(k) Plans and the Persistence of Their Use, 2007-2009*, EBRI.ORG, at 10 (Aug. 2011), [http://www.ebri.org/pdf/briefspdf/EBRI\\_IB\\_08-2011\\_No361\\_TDFs.pdf](http://www.ebri.org/pdf/briefspdf/EBRI_IB_08-2011_No361_TDFs.pdf).

enrollment. This would address the problem of employees staying in initial asset allocations.<sup>375</sup> Additionally this cures situations where an employee makes an initial investment allocation among plan investment options but then does not readjust the allocation balance as certain asset classes earn higher returns so that over a period of time a 70-20-10 allocation, as described above, could become a 80-18-2 allocation.

Another individual reform sticky default is an opt-out option for defined contribution benefits to be converted in whole or in part to an annuity at the time of retirement, rather than a lump sum payment. There may be cost advantages available to participants who purchase annuities at the time of retirement, rather than later in life, and through a plan, rather than individually. Annuities would mitigate some of the longevity risks borne by employees as well as the risks of market performance in retirement years when investments should be conservative to preserve accumulated savings.<sup>376</sup>

2. *Disclosures.* Individual reforms must also focus on the related issues of disclosures and financial literacy. To reform disclosures without providing participants with the tools to digest and utilize the information contained in the disclosures is a wasted effort that may be politically expedient but does little to mitigate the risks shifted onto citizen shareholders.<sup>377</sup> The issue of disclosures and financial education are hefty and complicated topics that warrant their own paper. The following brief discussion of disclosure and education issues raises some initial areas of reform and issues to be further considered in a more thorough treatment of these topics.

ERISA recently augmented participant disclosure requirements.<sup>378</sup> New regulations require fiduciaries to provide participants with (1) general plan information about investment options whether or not a brokerage-window is available,<sup>379</sup>

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375. See MUNNELL & SUNDÉN, *supra* note 6, at 93 (suggesting employers offer funds that adjust periodically according to the participant's age and risk tolerance level because it is "particularly important in view of plan participants' failure to diversify and their inertia with regard to changing investments over time").

376. See Zelinsky, *supra* note 5, at 526. Consider alternatively criticism that "[m]andatory annuitization may deter some, perhaps many, employees from participating in defined contribution plans or individual retirement accounts by imposing a restriction they consider onerous." *Id.*

377. See Rodrigues, *supra* note 112, at 1850 (noting that even though mandating disclosures is politically easy, recent research suggests disclosures are not enough to influence investor behavior).

378. See *Fact Sheet*, *supra* note 187, at 1-4.

379. Ron Lieber, *Seeking Investment Flexibility In a 401(k)*, N.Y. TIMES (July 8, 2011),

(2) disclosures of fees and expenses charged or deducted from participant accounts, and (3) load fees and other expenses associated with account actions.<sup>380</sup> In addition, participants will receive quarterly statements “showing the dollar amount of the plan-related fees and expenses (whether ‘administrative’ or ‘individual’) actually charged to or deducted from their individual accounts, along with a description of the services for which the charge or deduction was made.”<sup>381</sup>

Disclosures must also include for each investment option (1) performance data of the prior one-, five-, and ten-year returns,<sup>382</sup> and (2) benchmark data for non-fixed return rate options including historical returns of the market over one-, five-, and ten-year periods.<sup>383</sup> Participants also receive information regarding the total annual operating expenses, “expressed as both a percentage of assets and as a dollar amount for each \$1,000 invested” and restrictions on additional purchase or withdraw decisions.<sup>384</sup> In addition, all participant disclosures must include a website address with a glossary of investment-related terms to facilitate participant comprehension of disclosed information and additional investment information.<sup>385</sup> The fee transparency rules promulgated by the DOL correspond to the SEC Investment Company advertising rules which require sales materials to contain information not always found in the prospectus, such as disclosures regarding “investment objectives, risks, and fees, and to present explanatory information” prominently as well as include the most recent month-end performance data.<sup>386</sup>

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<http://www.nytimes.com/2011/07/09/your-money/401ks-and-similar-plans/a-401k-window-to-more-investing-choices-your-money.html?pagewanted=all> (“Your employer can simply add something called a self-directed option, also known as a brokerage or mutual fund window. At that point, your 401(k) or similar account becomes like a regular brokerage account, where you can buy any mutual or exchange-traded fund (and in some cases, any individual stock) you want.”).

380. 29 C.F.R. § 2550.404a-5 (2012); *Fact Sheet*, *supra* note 187, at 2.

381. *Fact Sheet*, *supra* note 187, at 2.

382. Investment options with fixed rates of return include bonds, CDs, and certain annuities.

383. *Fact Sheet*, *supra* note 187, at 2.

384. *Id.* at 2–3.

385. *Id.*; see also 29 C.F.R. § 2550.404a-5 (requiring fiduciaries to disclose a general glossary of terms to help participants understand investment alternatives or provide participants with a web address directing them to a glossary of terms).

386. Amendments to Investment Company Advertising Rules, 67 Fed. Reg. 36,712 (May 24, 2002) (to be codified at 17 C.F.R. pts. 230, 239, 270, & 274), available at <http://www.sec.gov/rules/final/33-8294.htm>; *SEC Amends Investment Company Advertising Rules*, FINRA (Jan. 8, 2004), <http://www.finra.org/Industry/Regulation/Guidance/MemberAlerts/2004/p002756>.



Increasing the information that employer sponsors must provide is the first step in disclosure and education reform. A second step should focus on simplifying, consolidating, and translating information into digestible and useable formats informed by behavioral economics to promote both comprehension and action. For example, inundation with mandatory information translates into noise that participants are likely to ignore.<sup>387</sup> Isolated information regarding individual investment options should be replaced with consolidated disclosures that provide a comparison among all options in a plan, as well as market averages for the asset class. For example, information regarding a TIAA-CREF Growth and Retail Fund would be compared with other growth-oriented mutual funds offered in the company's plan, as well as the market average for growth funds. This comparison data should include more than past returns, which are a poor indicator of future performance,<sup>388</sup> and should focus on fees and fee sharing arrangements. These comparisons would place the disclosed information into a context that would be useful for decision-making and disaggregate information relevant to investment allocation, especially in the contained universe of investing within a self-directed defined contribution plan.<sup>389</sup> The DOL and the SEC should also coordinate on the issue of required disclosures for assets commonly included in plans so that employers receive the necessary information from funds, which can then be reported to the DOL and disclosed to employee participants.

3. *Financial Education.* An issue closely related to disclosures is financial education. There is neither mandatory employer-provided investment education for participants in self-directed plans,<sup>390</sup> nor is there a financial literacy curriculum available in schools, despite the growing number of Americans who depend, or are likely to depend, on self-directed defined contribution

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387. See Rodrigues, *supra* note 112, at 1854.

388. Mercer, Palmiter & Taha, *supra* note 147, at 433–34 (“Extensive studies have found only ‘weak and controversial evidence that past performance has much, if any, predictive ability for future returns.’ In other words, little evidence of returns persistence exists; top performing funds generally do not continue to significantly outperform other funds.” (footnotes omitted)); Travis Sapp & Ashish Tiwari, *Does Stock Return Momentum Explain the “Smart Money” Effect?*, 59 J. FIN. 2605, 2607 (2004) (finding that fund flows into U.S. equity mutual funds “effectively demonstrate[] that fund investors appear to be chasing recent large returns”).

389. See Rodrigues, *supra* note 112, at 1852–53 (suggesting that salience of information is more important than the disclosure itself because “[i]nvestors, including professionals, have only limited attention to devote to processing information.”).

390. See 29 C.F.R. § 2509.96-1 n.1 (2006).

plans for retirement savings. Of the voluntary programs that are offered, observers are critical of current investor education programs offered by the DOL,<sup>391</sup> the agency charged with education under ERISA.<sup>392</sup> A primary criticism of the DOL is that it serves two masters under the ERISA framework: employer sponsors and employee participants.<sup>393</sup> ERISA's objective of protecting the rights and benefits of plan participants also includes avoiding undue administrative burdens on employers and preserving employers' right to customize plans.<sup>394</sup> The DOL was placed in a difficult situation where increased employee education would benefit employees but burden employer sponsors. Critics have suggested that the DOL struck a balance in favor of employer cost reduction and flexibility at the expense of education and employee protection.<sup>395</sup> The current situation is untenable because our defined contribution society is premised on the ability of individuals to manage retirement accounts during their working life and throughout retirement. That premise requires support for education in the form of a national curriculum or mandatory employer education.

Of course, investor education is not a cost-free proposition, and resources dedicated to education reform must be allocated to effective measures based upon current behavioral economic research.<sup>396</sup> For example, there are

specific segments of the U.S. population—those with low educational attainment and low income—that save in very different ways than more educated and affluent households. It may be important to target these groups

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391. See Medill, *supra* note 33, at 341–45.

392. Congress named the DOL as the lead agency under the SAVER Act. Savings Are Vital to Everyone's Retirement (SAVER) Act of 1997, Pub. L. No. 105-92, §§ 3, 111 Stat. 2139, 2139–40 (1997); see 29 U.S.C. §§ 1146–1447 (2006).

393. See Medill, *supra* note 33, at 344–45 (describing the DOL's competing goals of protecting the rights and benefits of plan participants and preserving the rights of employers).

394. *Id.* at 345.

395. *Id.* at 346 (suggesting the DOL's regulatory provisions were a “compromise necessary to encourage employers to sponsor participant-directed 401(k) plans,” but cannot “be reconciled with the need to provide workers with a vigorous and effective public educator”).

396. Zelinsky, *supra* note 5, at 526 (“Before mandating such education, we need rigorous proof that the results are likely to justify the costs. Without such data, a mandate for employer-provided investor education looks suspiciously like a windfall for the providers of that mandated education.”); see also *supra* note 195 and accompanying text (discussing how a policy based on the providing of information to participants that is never given, and on the assumption that participants will use information on their own in ways that they cannot, is a flawed concept).

and devise programs that are better tailored to their needs and barriers to saving.<sup>397</sup>

Additionally, some research suggests that “employer-provided educational materials are geared toward individuals who are natural ‘planners’ and that these materials do not appeal to the approximately 50% of the working population that is not planning-oriented.”<sup>398</sup>

Whatever education program is developed, it must take into account the breadth of participants who are given this responsibility with varying cultural and education backgrounds. For example at any university, faculty members, administrative staff in departments like financial aid and admissions, support staff for faculty and administrators, facilities staff like housekeeping, and executives of the university all invest in the same plan. Any education program must take into account these differences in audience in structuring a meaningful education tool.

### C. Conclusions

How people invest in the stock market has changed as a result of the retirement revolution from traditional pensions (defined benefit plans) to self-directed defined contribution plans like the 401(k). The prevalence of self-directed defined contribution plans has created a new class of investors—the citizen shareholders—who enter the securities market through retirement plans, invest for long-term savings goals, and are predominantly indirect shareholders. The policy shift pushed investors into the markets to save for the individually crucial and socially important goal of retirement financial security. Citizen shareholders are the fastest growing group of investors, but they have limited protections under corporate law, securities regulations, and ERISA.

Citizen shareholders do not fit within the traditional corporate law framework of shareholder rights because their indirect ownership status dilutes their information and voting rights, as well as exacerbates their rational apathy as diffuse and disempowered “owners.” The problems of indirect ownership are intensified in the context of employer-provided plans where investors’ choice to enter the market is constrained as is their ability to exit and secure adequate representation by mutual fund managers. Secondly, citizen shareholders are largely

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397. Lusardi, *supra* note 183, at 141.

398. Medill, *supra* note 33, at 338–39.

excluded from the original protections and safeguards offered under ERISA. Citizen shareholders bear the risk of market performance, account funding, longevity, and information risks—risks not borne by retirees under defined benefit plans. Third, because citizen shareholders exercise control over their investments by allocating savings into various pre-selected investment options, employer sponsors and other plan fiduciaries can claim a safe harbor affirmative defense against most liability. The safe harbor protects fiduciary breaches from liability and in many cases shields important structural plan decisions such as investment fees and options that significantly impact citizen shareholders' control over their accounts.

In this Article, I call attention to the retirement revolution and the resulting defined contribution society. If participants bear the ultimate risk, then they should be both fully informed as to the risks and equipped to manage them. I suggest reforms that mitigate and balance risks assumed by employee participants under our defined contribution society with structural reforms like augmented fiduciary duties for structural plan decisions and individual reforms focused on utilizing defaults, comparison-based disclosures and increased financial literacy programs.